CHARTING A STRONG FUTURE

HERITAGE OIL CORPORATION

2005 ANNUAL REPORT

HERITAGE
Oil Corporation

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ON THE COVER

The origins of astronomy go back to the third and second millennium before Christ in Egypt and Babylon. The Greeks, Indians, Arabs and the Persians consolidated the knowledge of humankind inherited in astronomy in the first 12 centuries of our own era.

This astrolabe, which is Indian and Persian, was an ingenious portable computer and observing instrument that had its roots in antiquity.

FINANCIAL CALENDAR 2006 *

May 15: First quarter results

June 22: Annual General Meeting

August 15: Second quarter results

November 15: Third quarter results

Heritage is listed on the Toronto Stock Exchange under the symbol HOC. For updated share prices and historical price, see **www.heritageoilcorp.com.**

**Subject to possible changes*

ANNUAL GENERAL MEETING

The annual meeting of shareholders of Heritage will be held June 22, 2006 at 3 p.m. in the Cardium Room of the Calgary Petroleum Club.

Shareholders are encouraged to attend the meeting, but those who are unable to do so are requested to sign and return the form of proxy.

ABBREVIATIONS

Oil and Natural Gas Liquids		Natural Gas	
Bbl	barrel	Mcf	thousand cubic feet
Bbls	barrels	Mmcf	million cubic feet
Mbs	thousand barrels	Mcf/d	thousand cubic feet per day
Mmbs	million barrels	Mmcf/d	million cubic feet per day
MMstb	million stock tank barrels	MMBTU	million British Thermal Units
Mstb	1,000 stock tank barrels	Bcf	billion cubic feet
Bpd/bopd	barrels per day	GJ	gigajoule
NGLs	natural gas liquids		

COMPANY PROFILE

Heritage Oil Corporation is a Canadian-based independent international oil and gas exploration, development and production company. The Company's principal producing properties are in the Republic of Congo and Oman. The Company holds a 95% interest in a substantial development property in Russia with significant oil reserves in place and a 50% interest in an exploration project in Uganda.

Through its subsidiary K Petroleum Company, Heritage has entered into MOUs with the Kurdistan Regional Government. Heritage has also established agreements with parties in Russia and Kazakhstan for the purpose of developing new project opportunities.

The Company's producing, development and exploration projects, together with potential prospects, provide significant opportunities for long term value creation to shareholders.

The Company's shares trade on the Toronto Stock Exchange ("TSX"), under the symbol HOC.

FORWARD-LOOKING INFORMATION

Certain information set forth in this document, including management's assessment of Heritage's future plans and operations, contains forward-looking statements that involve substantial known and unknown risks and uncertainties. These forward-looking statements are subject to numerous risks and uncertainties, certain of which are beyond Heritage's control, including the impact of general economic conditions, industry conditions, volatility of commodity prices, currency fluctuations, imprecision of reserve estimates, environmental risks, competition from other producers, the lack of available qualified personnel or management, stock market volatility and the ability to access sufficient capital from internal and external sources. Heritage's actual results, performance or achievement could differ materially from those expressed in, or implied by, these forward-looking statements and, accordingly, no assurance can be given that any events anticipated by the forward-looking statements will transpire or occur, or if any of them do, what benefits Heritage can derive therefrom. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

FINANCIAL AND OPERATIONAL HIGHLIGHTS

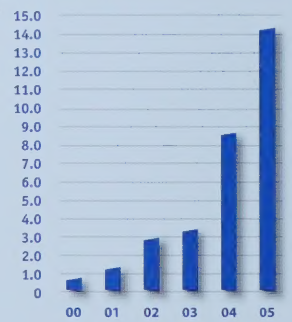
US DOLLAR MILLIONS EXCEPT FOR PER SHARE AND PER BARREL AMOUNTS

Financial	2005	2004	2003	2002	2001	2000
Petroleum and natural gas revenue	6.29	5.60	4.50	4.60	3.60	3.20
Earnings (loss) for the year	(3.80)	28.40	2.60	31.70	0.90	1.40
Basic earnings (loss) per share	(0.18)	1.33	0.13	1.67	0.06	0.10
Capital expenditures	20.55	37.30	7.10	10.70	3.10	1.40
Net assets	83.91	80.60	48.10	44.30	12.70	9.80
Debt	7.77	0.00	0.00	0.00	2.50	3.50
Average price per barrel	42.22	33.66	25.16	22.33	18.75	21.96
Production (barrels)	166,971	150,631	197,480	220,447	190,774	146,784
Reserves (Total Proved Plus Probable)(millions of barrels)	71.6	13.9	18.0	10.5	14.5	4.6
Share price as at December 31 (TSX share price, Cdn$)	14.45	8.65	3.40	3.00	1.40	0.80

ANNUAL PRODUCTION (BBLS)

EARNINGS PER SHARE (US$ PER SHARE)

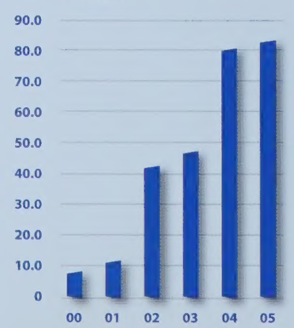
YEAR-END SHARE PRICE (CDN$)



PETROLEUM AND NATURAL GAS REVENUE (US$M)

EARNINGS FOR THE YEAR (US$MM)

NET ASSETS (US$MM)



ACHIEVEMENTS FROM 2005

- Acquisition of a 95% interest in the Russian company, ChumpassNefteDobycha Limited, whose sole asset is the Zapadno-Chumpasskoye License in West Siberia, Russia. This license contains the Zapadno-Chumpasskoye ("West Chumpass") Field.
- Through its 50%-owned subsidiary, K Petroleum Company, entering into two Memoranda of Understanding (MOUs) with the Oil, Gas and Petrochemical Establishment of Kurdistan, Iraq to undertake field studies in Kurdistan.
- The net present value of the proved and risked probable reserves, estimated by the independent evaluator, ECL Canada with support from RPS Scott Pickford Limited, was $407.9 million (constant prices discounted at 10%) at December 31, 2005, 703% higher than the previous year-end proved and risked probable value of $50.8 million.
- Total proved and risked probable reserves were 71.6 Mmboe as at December 31, 2005, 415% higher than at the previous year-end. Total proved and risked probable reserves were 13.9 Mmboe as at December 31, 2004.
- A 12% increase in petroleum and natural gas revenue from $5,592,721 in 2004 to $6,286,702 in 2005.
- Average production of 458 barrels per day ("bpd") in 2005, 11% higher than in 2004. Average production in 2004 was 413 bpd.
- Raising $60 million in March 2006 by the issuance of an unsecured, convertible bond with a term of five years. Heritage's current cash balance is more than sufficient to cover all of the planned capital expenditures and commitments for 2006.

LOOKING FORWARD

- Convert the current MOUs in Iraq into Production Sharing Agreements.
- Seek additional MOU opportunities in Iraq and complete a second training course for Ministry of Oil officials from Iraq.
- Commence production and complete the minimum work program obligation on the West Chumpass Field in Russia; seismic acquisition, interpretation of data and commencement of a five-well drilling program.
- Drill the Kingfisher prospect from the shores of Lake Albert, in Block 3A, Uganda. The Kingfisher prospect is one of several prospects and leads mapped within Lake Albert. It is a large prospect capable of containing several hundred million barrels of reserves.
- Aggressively seek to increase asset value by targeting timely acquisition of new assets. Notably in Russia, by acquiring "smaller" concessions from major companies and in Kazakhstan, through the joint venture entered into in early 2005.
- Consider disposing of non-core assets to generate cash.
- Consider a secondary stock market listing in Europe.

LETTER TO SHAREHOLDERS

Dear Shareholders,

It is my pleasure to report on the remarkable progress of your Company in 2005. Last year was one of solid growth, marked by several milestones in Heritage's development. Our achievements are the result of management's on-going strategy to focus on the acquisition of reserves and near-term production in new territories.

Our focus has been to participate in areas of the world with potential for huge oil fields. We have concentrated our efforts in the following key areas: Kurdistan, Russia, Iraq, Uganda and the CIS (primarily Kazakhstan). We are pleased to report that over the course of 2005, significant developments were made in Kurdistan and Russia. These developments mark the beginning of a new phase for Heritage as it positions itself to play an integral role in the oil and gas industry in these regions.

HIGHLIGHTS

The last twelve months have seen two major achievements. K Petroleum Company, a subsidiary of Heritage, entered into two Memoranda of Understanding with the Oil, Gas and Petrochemical Establishment of Kurdistan to undertake field studies. A 120-day fieldwork program commenced in the first MOU area in January 2006. The second and larger MOU area involves undertaking feasibility studies over several fields located south of the Erbil Mosul main road. Work is scheduled to commence shortly.

The second achievement came as the year closed. In December, we acquired a 95% equity interest in ChumpassNefteDobycha Limited, a Russian company whose sole asset is the Zapadno-Chumpasskoye License in West Siberia. This development project is independently estimated to have proved and probable reserves of 69 million barrels of oil (23 million proved and 46 million probable) net to Heritage. This acquisition marks Heritage's first step into a country with massive reserves that could translate into an opportunity for significant future growth, production and the opportunity to generate early cash flow.

In response to our various initiatives, Heritage's share price strengthened substantially in 2005. At year-end, Heritage shares closed at Cdn$14.45, a 67% increase from the previous year. The Company's prospects for oil exploration and development combined with higher oil prices, spurred a major influx of investor interest in Heritage during the fall.

STRATEGY

Heritage's strategy focuses on acquiring reserves and near-term production, which entails strategic joint ventures with influential local partners in countries with prolific oil and gas reserves. In large part, the inroads made by Heritage in its targeted countries resulted from management's significant historical roots, particularly in Kurdistan, Iraq and Russia. Heritage will continue to benefit from these roots as we try to capture additional opportunities.

Our strategy for 2006 will continue to focus on Kurdistan, Iraq, Russia and the CIS. All have promising natural resource potential that can be developed with our proven resources, historical relationships and business acumen. We intend to participate in this process. Additionally, Heritage will continue to explore in the Albert Graben, Uganda.

FINANCIAL INFORMATION

The net present value of the proved and risked probable reserves, estimated by ECL Canada with support from RPS Scott Pickford Limited, was $407.9 million (constant prices discounted at 10%) at December 31, 2005, 703% higher than the previous year-end value of $50.8 million. Total proved and risked probable reserves were 71.6 Mmboe as at December 31, 2005, 415% higher than the previous year-end reserves of 13.9 Mmboe.

Total revenues for 2005 increased 21% over 2004 to \$8,013,722, due to an increase in average commodity prices. The average sales price per barrel increased from \$33.66 in 2004 to \$42.22 in 2005.

The net loss for the full year was \$3,779,813 (Cdn\$4.4 million) in 2005, compared to net earnings of \$28,364,368 (Cdn\$34.2 million) in 2004. The net loss for the year is due in part to establishing a management and finance office in Switzerland and employing additional staff. Overall, the Company's activities expanded significantly during the last 12 months, notably linked to the acquisition of the Zapadno-Chumpasskoye ("West Chumpass") Field and the progress made with MOUs in Kurdistan, Iraq. Net earnings in 2004 were \$2,095,255 before taking into account the one-off gain on the sale of property of \$26,269,113.

In March 2006, Heritage completed a US\$60 million, 10% unsecured convertible, five year bond issue. The bonds, which were issued at par, are fully convertible any time at a conversion price of US\$18.00 per share, a premium of approximately 45% at the closing date. If entirely converted, the bond issue will lead to the issuance of an aggregate of 3,333,333 Common Shares. The funds raised are sufficient to cover Heritage's 2006 projected capital expenditures budget.

OUTLOOK FOR 2006

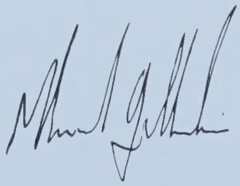
We are working in a sector that has experienced, and will continue to experience, tremendous demand. Going forward, some of our goals for 2006 include:

- Convert the MOUs in Kurdistan, Iraq to Production Sharing Agreements (PSAs).
- Commence the development of the West Chumpass Field in West Siberia, which will involve the acquisition of a 3D seismic survey of up to 300 km^2 (planned for the fourth quarter of this year), re-entering an existing well, and a five-well drilling program slated to commence in the final quarter of this year.
- Appraise further opportunities to acquire additional development and/or production projects in Russia.
- Appraise opportunities to acquire producing and/or development properties in Kazakhstan.
- Drill the Kingfisher Prospect from the shore of Lake Albert, Block 3A in Uganda. Kingfisher is a large prospect with the potential to contain several hundred million barrels of reserves.

Heritage is also considering the sale of certain of its non-core assets to maximize shareholder value and generate cash to finance more promising opportunities in the priority strategic areas being pursued. In addition, Heritage is considering a secondary listing in Europe to boost liquidity and introduce the Company to a wider investment audience.

Kurdistan, Iraq, Russia, the CIS and Uganda have the potential to transform Heritage Oil in the short-to-medium term into an intermediate-size oil producer operating in world-class hydrocarbon basins. With Heritage's resources and network of relationships, we will continue to evaluate opportunities through 2006 and beyond.

On behalf of the Board of Directors, we would like to thank all employees and investors of Heritage for their contributions and commitment to the Company. We are confident about the opportunities before us and look forward to continuing our trend of solid growth throughout 2006.



Micael Gulbenkian
Chairman and CEO
May 1, 2006

RESERVES

The Company's year-end reserve evaluation (the "Scott Pickford Report") effective December 31, 2005 was prepared by ECL Canada with support from RPS Scott Pickford Ltd., an independent petroleum engineering firm.

Under National Instrument 51-101 ("NI 51-101"), proved plus probable reserves now represent the most realistic estimate. The Company has total proved plus probable reserves of 71.6 Mmboe, at 2005 year-end.

Proved plus probable reserves have an estimated value of US$407.9 million at December 31, 2005 (at a constant price, assuming a discount rate of 10%), 703% higher than at the previous year-end. This increase arises from the acquisition of a 95% interest in the West Chumpass Field in December 2005.

Reserve Category	Area	Reserves (Mmboe)	NPV discounted at 10% (US$Mm)
Proved	Russia	23.1	80.8
	Congo	0.3	9.7
	Oman	0.6	2.6
Total Proved		24.0	93.1
Additional Probable	Russia	46.1	291.7
	Congo	1.2	20.9
	Oman	0.3	2.2
Total Proved Undeveloped		47.6	314.8
Total Proved plus Probable		**71.6**	**407.9**

The constant price assumptions assume the continuance of current laws, regulations and operating costs in effect on the date of the Scott Pickford Report. In addition, operating and capital costs have not been increased on an inflationary basis.

Product prices used by ECL Canada with support from RPS Scott Pickford in the constant price evaluation are set out below:

	Forecast Oil Price Congo	Forecast Oil Price Russia Export	Forecast Oil Price Russia Domestic	Forecast Gas Price Oman	Forecast Condensate Price Oman	Forecast LPG Price Oman
	US$/bbl	US$/bbl	US$/bbl	US$/MMBTU	US$/bbl	US$/tonne
Constant pricing	56.84	53.70	31.55	1.00	55.40	427.20

The following cautionary statements are specifically required by NI 51-101 and apply to each of the following tables.

1. Estimates of future net revenue used in calculating discounted and undiscounted net present values ("NPV") do not represent fair market value.

2. Due to the effects of aggregation, estimates of reserves and future net revenues for individual properties may not reflect the same confidence level as estimates of reserves and future net revenues for all properties.

3. A BOE conversion ratio of six mcf to one barrel of oil has been used. BOEs may be misleading, particularly if used in isolation. A BOE conversion ratio of six mcf to one barrel is based on an energy equivalency conversion method primarily applicable at the burner tip and does not represent a value equivalency at the wellhead.

4. The aggregate of exploration and development costs incurred in the most recent financial year and the change during that year in estimated future development costs generally will not reflect total finding and development costs related to reserves additions for that year.

The following tables, based on the Scott Pickford Report, summarizes the net oil, NGLs and natural gas reserves attributable to oil and natural gas interests of Heritage and the present value of future net revenue for such reserves using constant price assumptions and costs at a discount rate of 10%. All evaluations of future net production revenue set forth in the tables are stated after overriding and lessor royalties, freehold royalties, mineral taxes, direct lifting costs, operating costs and future investments. It should not be assumed that the discounted future net production revenues estimated by the Scott Pickford Report represent the fair market value of the reserves. Other assumptions and qualifications relating to costs, prices for future production and other matters are included in the Scott Pickford Report. There is no assurance that the future price and cost assumptions used in the Scott Pickford Report will prove accurate and variances could be material.

"**Gross**" reserves are defined as the total remaining recoverable reserves owned by the Company before deduction of any royalties.

"**Net**" reserves are defined as those accruing to the Company after royalties have been deducted or included.

The constant price assumptions assume the continuance of current laws, regulations and operating costs in effect on the date of the Scott Pickford Report. In addition, operating and capital costs have not been increased on an inflationary basis.

Petroleum and Natural Gas Reserves

	Russia light and medium crude oil (Mmbs)		Congo light and medium crude oil (Mmbs)		Oman-Gas (Bcf)		Oman-NGLs (Mmbs)		Oil Equivalent (MMBOE)	
	Gross	Net	Gross	Net	Gross	Net	Gross	Net	Gross	Net
Proved Producing	0.0	0.0	0.2	0.2	3.0	0.0	0.3	0.1	1.0	0.3
Proved Undeveloped	23.1	23.1	0.2	0.1	5.0	2.1	0.3	0.1	24.4	23.7
Total Proved	23.1	23.1	0.4	0.3	8.0	2.1	0.6	0.2	25.4	24.0
Probable Additional	46.1	46.1	1.6	1.2	6.1	1.5	0.4	0.2	49.1	47.6
Total Proved Plus Probable	**69.2**	**69.2**	**2.0**	**1.5**	**14.1**	**3.6**	**1.0**	**0.4**	**74.5**	**71.6**

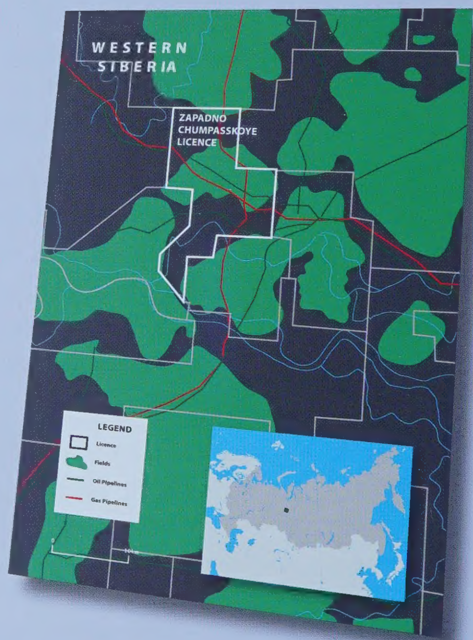
RUSSIA

RUSSIA

ZAPADNO-CHUMPASSKOYE LICENSE

In the fourth quarter of 2005, Heritage acquired a 95% equity interest in ChumpassNefteDobycha Limited, a Russian company whose sole asset is the Zapadno-Chumpasskoye License, an exploration and production permit previously held by Tyumenskaia Neftanaia Companiya (now known as TNK-BP).

Expiring in September 2024, the license is in West Siberia in the province of Khanty-Mansiysk, approximately 100 kilometres from the city of Nizhnevartovsk in the vicinity of TNK-BP's prolific Samotlor Field. It is located in an extremely hydrocarbon-rich province close to well-developed infrastructure. The license has an area of approximately 200 km^2 and contains the Zapadno-Chumpasskoye Field ("West Chumpass"), which was discovered in 1997. A total of nine wells have been drilled on the license. The reservoir is a sandstone of Late Jurassic age at a depth of approximately 2,700 metres, which is the same producing horizon as in a number of the neighbouring fields. On production test, the reservoir flowed sweet, 36 degree API crude with moderate gas oil ratios at rates up to 462 bopd per well, again typical for fields in the surrounding area.



KEY FACTS

ZAPADNO-CHUMPASSKOYE EXPLORATION AND DEVELOPMENT PERMIT

- Ownership: Heritage 95%

ECL Canada with support from RPS Scott Pickford estimated the Zapadno-Chumpasskoye License contains proved reserves of 23 million barrels and additional probable reserves of 46 million barrels net to Heritage. They also estimated the Net Present Value, discounted at 10%, at US$372 million on a constant price basis and US$237 million on an escalated price basis, net to Heritage, effective December 31, 2005.

The license has a work program commitment to acquire a minimum of 30 kilometres of 2D seismic and to drill no less than three wells. Heritage intends to meet this commitment by commencing the drilling of initial development wells before the end of 2006. As operator of the license, Heritage has already established an office in the city of Nizhnevartovsk and is building an operational and technical team there which has local experience with working in the region. Additionally, approximately 200 kilometres 2D seismic survey has been acquired in 2006.

STRATEGIC ALLIANCES

In early 2005, Heritage entered into talks with a private Russian company: TISE Holding Company ("TISE"). Shareholders of TISE include Gazprom, Zarubejneft, Technoexport and Zarubejmontajstroy. Following discussions with TISE, the management of Heritage is considering establishing a joint venture company with TISE and certain of its shareholders. This association should give Heritage access to projects with potentially prolific reserves and the financial wherewithal to bring them to production. The strength and stature of the partners should ensure operations are undertaken in an efficient and transparent manner.

REPUBLIC OF CONGO

KOUAKOUALA A PERMIT

The Kouakouala A Exploitation License is a development permit onshore the Republic of Congo in West Africa. The license was awarded in December 1996 and production from the Kouakouala field commenced in May 2000. The initial development permit expires in January 2008 with provision for a possible five year extension to January 2013.

The Kouakouala field was discovered by the previous licensee, Elf Aquitaine, in 1993. Production in 2005 was from four wells and achieved an average net production rate for Heritage for the year of 318 bopd.

Kouakouala-401 was placed on production in early 2005. It was drilled toward the end of 2004 to confirm the extension of the Vandji reservoir in the North Block of the field. Initial rates were good but deteriorated by mid-year as the well started to produce water.

Kouakoula-301ST well was drilled in January 2005 as a side-track to the previously suspended appraisal well Kouakouala-301 to test the water production potential of the Vandji reservoir as a source for future water injection implementation. The results confirmed that the reservoir in the North West block of the field was undepleted and from the production test on the well, it was confirmed that the water quality was compatible for water injection purposes. However, due to the large degree of reservoir pressure depletion observed during the test, it was also confirmed that the required water injection volumes required to optimize oil recovery could not be obtained from this well alone.

KEY FACTS

KOUAKOUALA A DEVELOPMENT PERMIT

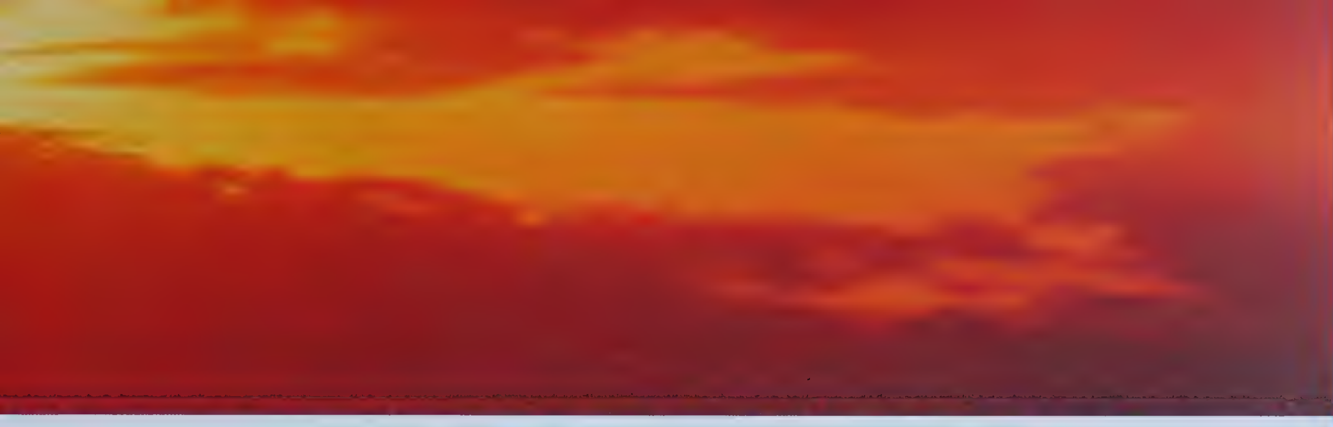
- Ownership: Heritage 25%, Maurel & Prom (operator) 50%, Tacoma Resources (Burren Energy plc) 25%.

KOUAKOUALA B DEVELOPMENT PERMIT

- Ownership: Heritage 30%, Maurel et Prom (operator) 35%, Tacoma Resources (Burren Energy plc) 35%.

NOUMBI EXPLORATION PERMIT

- Ownership: Heritage 14%, Maurel & Prom (operator) 49%, Tacoma Resources (Burren Energy plc) 37%.



Kouakouala-203 was drilled in February 2005 as an appraisal well in the South block of the field. Unfortunately, the reservoir was found to be cut-out by a fault and only the lower, poor quality base of the Vandji was encountered. Gas shows were observed during drilling in this section, although on test, the well failed to produce due to poor reservoir quality. It is possible the well could be side-tracked updip and away from the fault in the future to further evaluate the presence of oil in the South block. The Djeno water-bearing reservoir, encountered shallower in the well, may also be tested as a possible alternative source of water for future water injection once such plans have been firmed up.

An upgrade to the production facility is planned in 2006 to improve the current water separation and disposal facilities, improve the treatment of wax in the wells and facilities and to perform some further safety upgrades.

The implementation of water injection is considered essential and should be carried out once the approval of the development permit extension has been ratified by the Congolese authorities. A further production well is planned once ratification has been received.

A six-inch pipeline connects the Kouakouala field to the former producing Mengo field, which links into a 12-inch line. This allows export of Kouakouala production to the Djeno oil export terminal on the Atlantic coast.

KOUAKOUALA B PERMIT

The Mengo field in the Kouakouala B permit has a very large STOIIP (estimated by ECL Canada with support from RPS Scott Pickford to be up to two billion barrels), much of which has been proven by previous drilling. Although the field was shut-in by Elf in 1993 due to falling production rates, it is believed that with the application of up-to-date drilling and production technology, the field can be successfully redeveloped.

Mindful of the immense potential of the basal Vandji sandstone reservoir play along the basin margin (the notable successes being the giant M'Boundi field and the Kouakouala field), it is recognized that significant Vandji potential also exists in the Kouakouala B permit. The geological structure of the overlying Mengo field appears to be supported from beneath by a basement high and associated Vandji structures.

NOUMBI PERMIT

The Noumbi exploration license lies to the north of the Kouilou permit where the giant M'Boundi oil field is located. The permit holds considerable potential for discovering additional oil reserves in the same Vandji sandstone reservoir as both the Kouakouala and M'Boundi fields. The principal target is the Doungou prospect, which was identified by seismic shot in the 1980s. The Noumbi license was awarded in 2003 despite heavy competition from a number of other oil companies. Final ratification of the license award by the Congolese authorities was received in March 2006.

Plans are in place to drill the highly prospective Doungou prospect in 2006.

UGANDA

BLOCK 3A

The original Block 3 license was awarded in 1997 and all but an area of 11 km^2 centered upon the Turaco wells was relinquished in 2004. This remaining area was relinquished when the license expired in 2005. The Turaco-3 appraisal well, drilled in 2004 on the landward part of the license in an area known as the Semliki flats, production tested gas with high concentrations of carbon dioxide.

Block 3A license, which covers an area very similar to the original Block 3 license, was awarded in 2004. The Block covers an area of 3,777 km^2. During 2005, a sampling program was conducted, both in the flats and on Lake Albert to the north, in order to determine the genesis and migration of this carbon dioxide. The results of this study strongly suggest that the presence of carbon dioxide in the license significantly decreases northwards towards the lake. Also, in 2005 a 113 kilometre in-fill seismic program was acquired in Lake Albert over the Kingfisher prospect.

The sediments within the subsurface geological section underlying Lake Albert have been evaluated to represent a significant source for the generation of oil. The recent discovery of oil on the shores of the lake by Hardman Resources in its Mputa-1 and Waraga-1 wells in Block 2, immediately to the north of the Kingfisher prospect, makes this area of the lake lying within the license highly prospective.

Hardman reported that Mputa-1 recovered samples of black oil and had oil and gas readings over a gross interval of 220 metres. This well definitively proved the presence of all the components of a working petroleum system in the basin, namely mature source rock, good quality reservoir, a valid trap and sealing shale formations. Hardman's second well, Waraga-1, reportedly appears to be even more encouraging, as it recovered light oil samples which suggest an oil column of 45 metres. Hardman has reported it intends to production test its wells as soon as it can mobilize test equipment.

The Kingfisher prospect is one of several prospects and leads mapped within Lake Albert. It is a large prospect capable of containing several hundred million barrels of reserves. Preparations are currently underway to drill the Kingfisher prospect in 2006. Eagle Drill, in which Heritage has a 50% interest, has successfully drilled two wells in Block 2 and will drill this prospect.

BLOCK 1

Block 1 was awarded in 2004 in order to consolidate the Company's position in the basin. The block covers an area of 4,285 km^2. Preliminary studies are currently under way prior to planned seismic acquisition in 2006 or 2007, but already early indications suggest that this license is a prospective area.

KEY FACTS

BLOCK 3A, LICENSE 2/04 EXPLORATION AREA

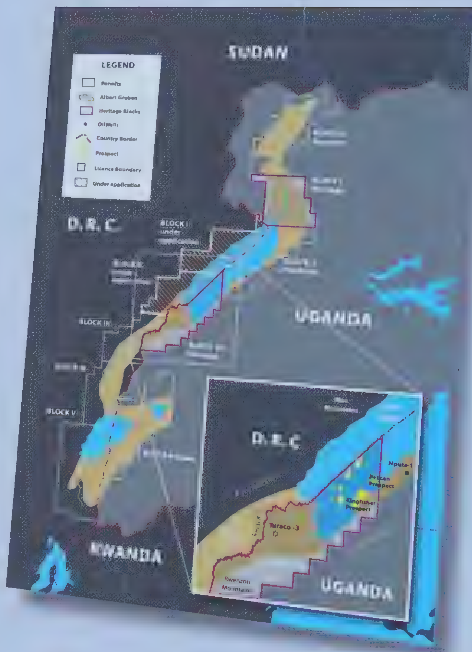
- Ownership: Heritage 50% (operator), Energy Africa (Tullow Oil plc) 50%.

BLOCK 1, LICENSE 1/04 EXPLORATION AREA

- Ownership: Heritage 50% (operator), Energy Africa (Tullow Oil plc) 50%.

Blocks 3A and 1 are located in the Albert Graben, a sedimentary basin which forms part of the western arm of the East African rift valley bordering the Democratic Republic of Congo.

The exploration work program moves northwards into Lake Albert to drill the prospective Kingfisher prospect in 2006.



SULTANATE OF OMAN

BLOCK 8, BUKHA FIELD

Block 8 covers 379 km^2 in about 90 metres of water roughly 12 kilometres offshore Oman, representing Oman's only offshore production.

The Bukha field produces from wells Bukha-1 and Bukha-2 and commenced production in 1994. During 2005, average daily gross production of the field was 30.10 mmcf/d gas, 1,298 bpd condensate and 778 bpd liquid petroleum gas (LPG). Heritage's share of the production in 2005 averaged 69 bpd condensate and 71 bpd LPG. As such, total net liquids production declined from 218 bpd in 2004 to 208 bpd in 2005, which is in-line with expectations from this mature asset. Wet gas is produced through an unmanned platform and a 34 kilometre pipeline to a plant onshore Ras-al-Khaimah. The partners currently receive no revenue for the gas production. Future gas sales to the growing domestic market in the United Arab Emirates (UAE) can be realized from additional wells on the Bukha field, as well as production from the Company's other future producing fields in Oman.

KEY FACTS

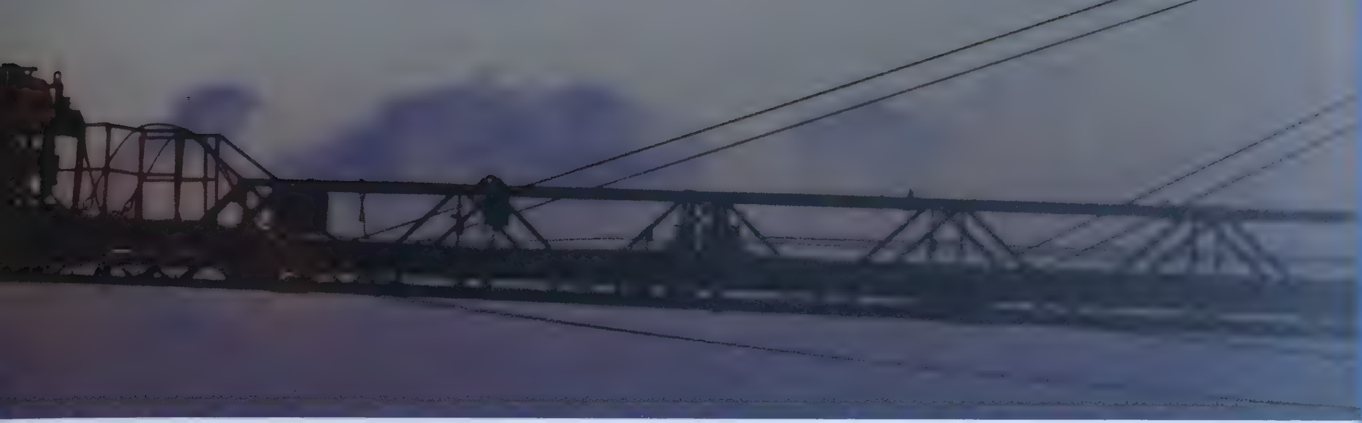
BLOCK 8 DEVELOPMENT PERMIT (CONTAINS THE BUKHA FIELD)

- Ownership: Heritage 10%, Indago Petroleum 40% (operator), LG International 50%.

BLOCK 17 EXPLORATION PERMIT

- Ownership: Heritage 10%, Indago Petroleum 40% (operator), Atlantis 50%.

The West Bukha appraisal well is expected to be drilled in 2006, potentially leading to fast-track phased development of the West Bukha gas-condensate field.



BLOCK 8, WEST BUKHA FIELD

The West Bukha/Hengam field extends over the Oman-Iran border in the straights of Hormuz, approximately 30 kilometres west of the Musandam Peninsula in about 90 metres of water.

The discovery well, Hengam-1, flowed at rates of up to 58 mmcf/d of gas having a condensate yield of approximately 225 b/mmcf, over twice as high as the initial condensate yield recorded from the Bukha field. The operator, Indago, has prepared a development plan that is fully supported by the Omani authorities to produce 320 bcf on the Omani side of the field. Unitization of the field has not been possible, despite discussions with both Governments.

The implementation of this development plan is conditional upon the drilling and testing of a successful appraisal well, which the joint venture intends to drill in the second quarter of 2006. If successful, the fast-track phased development of the field would follow.

BLOCK 17, TIBAT DISCOVERY

Block 17 is an exploration license containing all of the onshore Musandam Peninsula and surrounding near-shore waters within three miles, and includes the separate Madha area to the south.

The Tibat discovery is located astride the Block 17/Block 8 boundary. The Tibat-1 well was a gas-condensate discovery, drilled in 2002, which confirmed a 185 metre gross hydrocarbon column. The well tested up to 16 mmcf/d of gas, with associated condensate production rates of 75 b/mmcf. Analysis of the production test data also confirmed certain zones contain water and others display relatively high levels of carbon dioxide, nitrogen and inert gases.

The partners have considered a more crestal location for the next appraisal well, Tibat-2, with the aim of accessing an estimated 200 metres of reservoir located structurally higher and of better reservoir quality than recorded in the Tibat-1 well.

KURDISTAN, IRAQ

In 2004, the Company formed a strategic alliance by way of a joint venture with a major economic and industrial entity within Kurdistan, Iraq, which incorporated a jointly-owned company, Heritage Erbil Oil Limited ("Heritage Erbil"), which in turn has incorporated a 100%-owned subsidiary, K Petroleum Company ("KPC"). Heritage is responsible for the overall management and operation of Heritage Erbil and KPC.

KPC established an office in Erbil in 2005, staffed with oil company personnel.

KPC has signed two Memoranda of Understanding ("MOUs") with the Oil, Gas and Petrochemical Establishment ("OGE") of Kurdistan, Iraq.

The first covers an approximate 300 km^2 area adjacent to the Taq Taq oilfield. Geological fieldwork in the first MOU area commenced in January 2006. The planned 120-day field program includes undertaking magnetic and gravity studies as well as geological fieldwork. This work is being undertaken without any prevailing logistical or operational issues.

The second exclusive MOU covers an area of approximately 1,000 km^2 located south of the Erbil Mosul road in Kurdistan, Iraq. KPC commenced a work program in January 2006, including regional studies, geological field mapping, magnetic and gravity surveys and satellite data interpretation. Additionally, the scope of work shall include the determination of hydrocarbon in place volumes and reserves from

KEY FACTS

KPC HAS ENTERED INTO TWO MOUs

- Ownership: 50% interest in KPC

Fieldwork has commenced. Heritage anticipates converting the MOUs to PSAs in the first half of 2006.

interpretation of all available data, utilising the latest reservoir characterisation and modelling technology.

It is anticipated that both MOUs will be converted to Production Sharing Agreements during the first half of 2006. Iraq's new constitution, entered into in 2005, gives the Kurdistan Regional Government the exclusive authority to enter into oil and gas licenses over exploration areas and non-producing fields within its territory. KPC and Heritage have kept the Ministry of Oil in Baghdad fully informed of all developments.

Kurdistan and northern Iraq are reported to hold about one third of the reserves of Iraq, which are estimated to be 112 billion barrels of oil and 100 trillion cubic feet of gas already proven, yet less than 10% of the region has been explored.

The Company views the establishment of KPC as a crucial element in the development of Heritage and in the future expects KPC to play an important part in the development of Kurdistan's considerable hydrocarbon potential.

NEW VENTURES

IRAQ

Iraq has the second largest oil reserves in the world with 112 billion barrels of proven reserves and up to 300 billion barrels of probable reserves. Daily production from Iraq is approximately two million barrels, which is expected to increase to approximately nine million barrels within 10 years.

Heritage Middle East Limited, a wholly-owned subsidiary, is focusing on Iraq. This company has opened an office in Amman, Jordan, which will relocate to Baghdad when the security situation improves.

Heritage is committed to being a part of the oil and gas industry in Iraq and is looking to enter into exclusive desk-top field studies over a number of fields so that the Company will be well-positioned to be awarded licenses when new hydrocarbon laws have been passed.

Heritage Middle East continues to discuss with and maintains good relationships with the Ministry of Oil. Heritage commenced its collaboration with the Ministry of Oil of Iraq in 2004 by co-sponsoring a course to train 25 officials from the Ministry of Oil in Portugal. This was so successful that the Company is looking to undertake another course this year. Heritage considers these programs as part of its long-term commitments to Iraq.

Discussions with these officials will continue as the framework for the development of the oil and gas industry in Iraq evolves over the course of the next few years. The Ministry of Oil has recently nominated their members for a joint steering committee to be formed with Heritage Middle East. A MOU should be signed shortly for technical co-operation.

NEW TECHNOLOGY

EAGLE DRILL

Heritage and Energy Africa Limited of South Africa (owned by Tullow and Heritage's partner in Uganda), are joint owners of Eagle Drill. The Company was incorporated in 2002 and Heritage was appointed to manage it on behalf of the owners. The Company owns one drill rig that has undergone two major refits since its acquisition. The rig was used to drill the first two exploration wells in Uganda. The Company has also leased a conventional rig which has been used to drill the two well program in Block 2, Uganda that commenced at the end of 2005.

The Eagle Drill rig has many advantages over a conventional rig and allows Heritage to exploit niche opportunities.

The cost benefits of using the Eagle Drill rig in Heritage's drilling activities in Uganda have been considerable. The rig is lightweight, highly manoeuvrable, and capable of being barge-mounted for drilling on lakes. Meanwhile, it provides a flexible and cost-effective unit to pursue Heritage's future exploration work program both in Uganda and also in other countries.

The Eagle Drill rig is now capable of drilling conventional wells to a depth of 3,000 metres.

NATURAL PIPELAY WORLDWIDE LIMITED

In 2003, Heritage acquired a 33% interest in Natural Pipelay Worldwide Limited (NPWL), which was increased to 65% during 2004 in return for continuing to finance the company. NPWL is a technology company which holds and markets technology relating to the Buoyant Drum Lay System. Patent protection for the design has been secured and is held in NPWL's sister company, Naturalay Technologies Limited.

The system comprises a vessel with a large drum floating in a moon pool, allowing very long lengths of pipe to be continuously laid. The drum can carry up to 8,000 tonnes of pipe of diameters from four inches to 16 inches. This represents, for example, over 1,000 km of four inch diameter steel pipeline. The vessel can lay up to 50 kilometres of pipe in a day, compared to between two and three km for a conventional pipeline, thereby achieving substantial cost savings.

NPWL and Natural Technology:

- Hold the exclusive, worldwide license on the Intellectual Property Rights on the Buoyant Drum Lay System from Naturalay Technologies Limited.
- Will license the Buoyant Drum Lay System to third parties. NPWL or Natural Technology will not own the vessel.
- Will receive royalties for the use of the Buoyant Drum Lay System.
- Will provide support services for the construction, installation and operation of the Buoyant Drum Lay System in vessels.

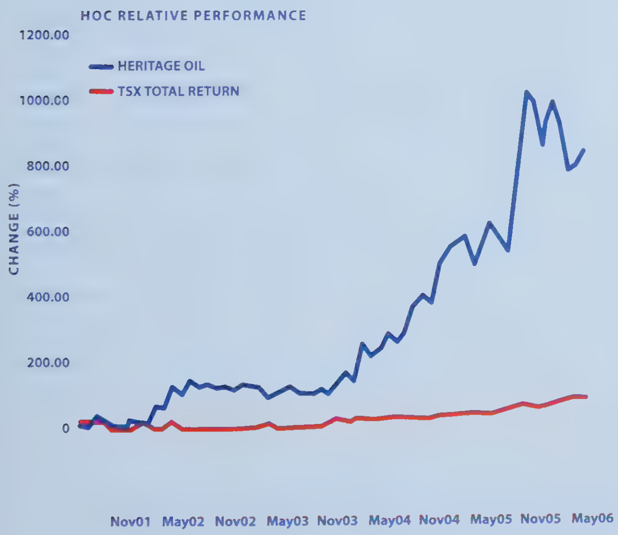
There is a further competitive advantage to Heritage. The cost savings achieved by utilizing the Buoyant Drum Lay System means that the Company can acquire stranded gas fields that were considered uneconomic using conventional pipe laying technology.

Further information on the Buoyant Drum Lay System is set out on www.naturalpipelay.com.

SHAREHOLDER ISSUES

Heritage continues to create financial value for its shareholders through selected asset acquisitions, development and dispositions. As is typical in the sector, long-term returns to shareholders should reflect the value created in the Company, primarily in the form of a higher share price. Over time, value added will be reflected to a greater extent by an increased share price rather than through dividend distributions, although the Company will consider returning any surplus windfall cash to shareholders if the Directors believe it cannot be used in the short-term for development purposes.

In 2005, shareholder value continued to improve significantly, with the share price rising by 67%. The share price has continued to rise since the year end, hitting a new high of Cdn$18.40 per share compared to the closing price of Cdn$14.45 as at December 31, 2005. Over the course of the last year the share price outperformed the TSX Total Return Index by over 100%. Trading volumes continued to strengthen in 2005. This is partly a result of the concerted program of investor information events that the Company undertakes, together with share buy-backs which commenced in June 2002. Heritage considers that these programs are an important use of funds, as it believes that the current market price of the Common Shares represents a discount to the fair value.



The Company continues to assess means of generating shareholder value and is examining a secondary listing in Europe. A secondary listing is expected to increase trading volumes and introduce the Company to a wider investor audience which could result in increased shareholder values.

During the year the Heritage website was re-launched and is now bilingual in English and French. This is consistent with the Company's plans to broaden the potential audience.

In order to capture the greatest possible value over time, it is imperative that the Company has at its disposal adequate financial resources. Heritage is continually developing new programs to communicate and meet with the financial community. This has included appointing investor relations experts and financial advisers, as well as attending and speaking at leading oil and gas conferences.

The Company strives to provide investors with the best possible basis for share price determination by means of accurate, comprehensive and timely information. Updated information can be found on the website www.heritageoilcorp.com.

In order to focus attention on shareholder value and the overall goals of the Company, Heritage periodically issues stock options as part of the remuneration package to Directors and senior management.

DIRECTORS AND SENIOR MANAGEMENT TEAM

MICAEL GULBENKIAN

Chairman and CEO

Mr. Gulbenkian joined the Board in 2001 and was appointed CEO in 2003. He headed the oil and gas interests of the Calouste Gulbenkian Foundation for more than two decades and has held various leadership positions within the Partex Group owned by the Foundation. His main responsibilities were developing its extensive international oil and gas interests in conjunction with its major multi-national partners, particularly in the Middle East.

ANTHONY BUCKINGHAM

Director

Mr. Buckingham is the founder of the Heritage Group. Mr. Buckingham commenced his involvement in the oil industry as a North Sea Diver and subsequently became a concession negotiator acting for several companies including Ranger Oil Limited and Premier Oil plc.

PAUL ATHERTON

Chief Financial Officer, Director

Mr. Atherton is a quied accountant, having qualified with Deloitte & Touche, and holds a degree in geology. He has a corporate finance background with specific experience in the international mining and resource sectors. He joined Heritage in 2000 and was appointed as a director in 2005.

WILLIAM KAUFMANN

Non Executive Director

Mr. Kaufmann holds an MA in Geology. He has held senior management positions in the petroleum industry including President of Canterra Petroleum Inc. (U.S.A.) from 1983 to 1986 and Senior Vice President of Exploration of Canterra Energy from 1981 to 1988. Until 1998, Mr. Kaufmann was the COO of the Calgary Chamber of Commerce. Mr. Kaufmann is a director of University Technology International, the McMahon Stadium Society and Bow Valley College.

JOHN MCLEOD

Non Executive Director

Mr. McLeod is a professional engineer with over 30 years of varied resources extraction experience. He is the President of McLeod Petroleum Consulting Limited, the President, CEO and a director of Onco Petroleum has held senior management positions. He also has served on various boards including Constellation Oil & Gas Ltd.; President and CEO of Arakis Energy Company; VP, Operations of Pengrowth Gas Company; Canoro Resources; Highview Resources, Rally Energy Corp. and CanArgo Energy Inc.

GREGORY TURNBULL

Non Executive Director

Mr. Turnbull is the Regional Managing Partner of the Calgary office of the law firm of McCarthy Tétrault LLP. During his 25 year career with various legal practices, he has dealt with all aspects of public companies. He has been actively involved in the IPOs of more than 40 companies. Mr. Turnbull has experience in a variety of corporate activities as well as an extensive knowledge of corporate governance issues and has acted for many boards of directors and special committees in that regard.

MICHAEL HIBBERD

Non Executive Director

Mr. Hibberd has extensive international energy project planning and capital markets experience, having spent 12 years in corporate finance with ScotiaMcLeod, where he was a director and Senior Vice-President, Corporate Finance. Mr. Hibberd is currently President of MJH Services Inc., corporate finance advisors, and serves as a director of AltaCanada Energy Corp., Challenger Energy Corp., Iteration Energy Ltd, Pan Orient Energy Corp. and Rally Energy Corp. Mr. Hibberd also served as a director of Deer Creek Energy Limited until December 2005. Mr. Hibbard joined the Board in March 2006.

PAUL BARNETT

VP Production

Mr. Barnett has over 25 years experience in the oil industry. Having qualified as a Petroleum Engineer in 1979, he worked for Shell for 18 years in a variety of international postings. Mr. Barnett left Shell in 1997 to become Operations Director of Wintershall and later worked in Algeria on behalf of Anadarko. He joined Heritage in 2005.

ARMEN SAHAKIAN

VP Business Development

Dr. Sahakian has a PhD in geology from Harvard. Dr. Sahakian has held senior management positions in the petroleum industry for a number of companies specializing in business development in Russia and the CIS. He has previously worked for Conoco, Partex and the World Bank's Oil and Gas Division.

BRIAN SMITH

VP Exploration

Mr. Smith has 27 years experience in the oil industry. He initially worked as exploration geologist for Exxon in the North Sea and Gulf of Mexico. Later he joined Enterprise Oil where he managed various exploration projects in the Far East and Eastern Europe/FSU. He joined Heritage as Vice President, Exploration in 1997.

JAMIL (JAMES) BABAN

Country Manager, Kurdistan

Mr. Baban has over 30 years experience in the upstream oil industry. Having qualified as a Petroleum Engineer, he has worked for Petro-Canada, Burlington Resources, Veba Oil, BP & BG. Mr. Baban has extensive skills in international projects and management, having worked in the Middle East, Far East and North Africa. Mr. Baban, who is multi-lingual, including Kurdish and Arabic, joined Heritage in 2005.

CORPORATE GOVERNANCE

The Directors are committed to maintaining the highest standards of corporate governance and this statement describes how the Principles of Good Corporate Governance are applied.

BOARD COMPOSITION

The Board consists of seven directors of which four are non-executive Canadian directors. The non-executive directors are experienced independent energy professionals from the legal, financial, technical and management sectors providing a range of expertise and experience.

ROLE OF THE BOARD

The primary duties and responsibilities of the Board of Directors are to:

- Approve, monitor and provide guidance on the strategic planning process. The Chairman & CEO and senior management team have direct responsibility for the ongoing strategic planning process and the establishment of long-term goals for the Company.
- Identify the principal risks of the Company's business and take reasonable steps to ensure the implementation of appropriate systems to manage and monitor these risks.
- Delegate to the Chairman & CEO the authority to manage and supervise the business of the Company, including the making of all decisions regarding the Company's operations that are not specifically reserved to the Board of Directors under the terms of that delegation of authority. The Board also determines what, if any, executive limitations may be required in the exercise of the authority delegated to management, and in this regard approves operational policies within which management will operate.
- Monitor the Company's financial position and approve budgets.
- Oversee the integrity of the Company's internal control and management information systems.
- Oversee effective communication with shareholders.

The Board meets regularly throughout the year and all the necessary information is supplied to the Directors on a timely basis to enable them to execute their duties effectively.

AUDIT COMMITTEE

The purpose of Heritage's Audit Committee is to provide assistance to the Board of Directors of Heritage in fulfilling its legal and fiduciary obligations with respect to matters involving the accounting, auditing, financial reporting, internal control and legal compliance functions of the Company and its subsidiaries.

The Audit Committee is responsible for the review and approval of the quarterly financial statements, management's discussion and analysis, all press releases containing financial disclosure, and the Company's oil and gas reserves reporting. The committee recommends to the Board the appointment and remuneration of the external auditors. The external auditors report directly to the committee. All non-audit work performed by the external auditors is to be approved by the committee. The committee also has oversight responsibility for the internal control systems that management has established.

The Audit Committee is composed of William Kaufmann, John McLeod and Michael Hibberd. Committee members are independent and financially literate.

INDEPENDENT EXTERNAL ADVICE

The Board or individual directors may request the provision of independent professional advice in relation to exercising their duties as directors at the Company's expense upon approval of the Chairman.

FINANCIAL RISK MANAGEMENT

The Board maintains oversight responsibility for the risk management programs relating to commodity prices, foreign exchange, interest rates and credit risks.

SHAREHOLDER COMMUNICATIONS

The Board aims to ensure that shareholders are informed of all major issues affecting the Company's state of affairs, reporting to shareholders through its quarterly and annual reports plus press releases. Procedures are in place to ensure price sensitive information is reported to the TSX and the securities commissions in advance with disclosure requirements. Regular updates to record news and results are published on the Company's website (www.heritageoilcorp.com), which also has a link to the TSX so that the Company's share price may be monitored.

Management's Discussion & Analysis

The following discussion and analysis (the "MD&A") is dated March 27, 2006 and should be read in conjunction with the Company's audited consolidated financial statements for the years ended December 31, 2005 and 2004, together with accompanying notes.

The MD&A is management's view of Heritage Oil Corporation's ("the Company" or "Heritage") operating and financial data for 2005 and 2004, as well as forward-looking operations and financial estimates. Actual results will vary from forward-looking estimates and the variations may be significant. The risks, uncertainties and other factors that could influence actual results are described in Business Risks and Uncertainties below.

The MD&A is presented in six sections:

Business Strategy provides a description of the Company's development strategies.

Operational and Financial Highlights provides a summary of the operations review and financial statement analysis for the year.

Detailed Financial Analysis provides a detailed analysis of the Company's financial performance by focusing on the income statement, the balance sheet and the statement of cash flows that are included within the audited financial statements.

Selected Quarterly Information provides the Company's key financial results, such as petroleum sales and net earnings, as well as the trading range of the Common Shares on a quarterly basis.

Critical Accounting Estimates provides a discussion of the more significant accounting policies. These are intended to enhance investors' understanding regarding the sensitivity of reported financial results to the methods, assumptions, and estimates that underlie the preparation of the financial statements in accordance with generally accepted accounting principles.

Business Risks and Uncertainties provides a discussion of the various business risks the Company is exposed to and the measures it follows to mitigate these risks.

BUSINESS STRATEGY

Heritage's goal is to deliver growth in shareholder value, by applying the following strategy:

- Investment in world-class hydrocarbon basins primarily in the Middle East, Russia, the Commonwealth of Independent States (CIS) and Africa. In certain of these countries, members of the management team have excellent relationships that transcend generations.
- Investing in properties that either are already producing or are close to producing and that generally represent relatively low exploration risk.
- Management of technical and political risk through a geographic spread of licenses, and an experienced hands-on management team who maintain good relations with partners and Governments.

This strategy is currently focused on the following prolific hydrocarbon areas: Kurdistan, Iraq, Russia and the CIS (Kazakhstan) and on potential hydrocarbons areas in Africa. Significant increases in the Company's market value are expected to be achieved:

- Externally, by joint ventures with established local parties in need of the support of an international oil and gas company. During 2004 and 2005, Heritage entered into a number of strategic joint ventures, including inter alia with parties in Kurdistan, Russia and Kazakhstan. The Company will continue to search for further joint ventures in the future.
- Externally, by acquisition. Through its network of privileged relationships, the Company has been able to identify a number of attractive potential acquisitions that were screened during the last two years and continue to be appraised.

- Internally, through drilling programs in the Middle East, Russia and Africa in 2006.
- Internally, by negotiating the award of new license concessions.
- Internally, by the disposal of non-core assets, which will generate cash flow.

Heritage will continue to seek new opportunities that focus on maximizing reserves and enhancing production.

OPERATIONAL AND FINANCIAL HIGHLIGHTS

Heritage's operating and financial highlights for the last 12 months include the following (all values are in US dollars except where otherwise stated):

- Acquisition of a 95% interest in the Russian company, ChumpassNefteDobycha Limited, whose sole asset is the Zapadno-Chumpasskoye License in West Siberia, Russia. This license contains the West Chumpass field.
- Through its 50%-owned subsidiary, K Petroleum Company, entering into two Memoranda of Understanding ("MOU") with the Oil, Gas and Petrochemical Establishment of Kurdistan, Iraq to undertake field studies in Kurdistan.
- The net present value of the proved and risked probable reserves, estimated by the independent evaluator, ECL Canada with support from RPS Scott Pickford Limited, was $407.9 million (constant prices discounted at 10%) at December 31, 2005, 703% higher than the previous year-end proved and risked probable value of $50.8 million.
- Total proved and risked probable reserves were 71.6 Mmboe as at December 31, 2005, 415% higher than at the previous year-end. Total proved and risked probable reserves were 13.9 Mmboe as at December 31, 2004.
- A 12% increase in petroleum and natural gas revenue from $5,592,721 in 2004 to $6,286,702 in 2005.
- Average production of 458 barrels per day ("bpd") in 2005, 11% higher than in 2004. Average production in 2004 was 413 bpd.
- In spite of the 2005 production increase, due to the periodic nature of condensate sales from the Bukha field in Oman, sales volumes in 2005 of 148,913 boe were actually 10% lower than in 2004.

	2005 $	2004 $	2005 $/bbl (1)	2004 $/bbl (1)
Revenue				
Petroleum and natural gas	**6,286,702**	5,592,721	**42.22**	33.66
Interest	**371,651**	560,926	**2.50**	3.38
Other	**1,355,369**	443,335	**9.10**	2.67
	8,013,722	6,596,982	**53.82**	39.71

MANAGEMENT'S DISCUSSION & ANALYSIS

	2005 $	2004 $	2005 $/bbl (1)	2004 $/bbl (1)
Expenses				
Operating	**1,653,657**	1,442,016	**11.10**	8.68
Royalties	**816,740**	345,656	**5.48**	2.08
General & administrative	**5,249,862**	2,633,667	**35.25**	15.85
Interest	**491,824**	-	**3.30**	-
Foreign exchange losses (gains)	**1,240,529**	(1,488,026)	**N/A**	N/A
Depletion, depreciation and accretion	**1,636,008**	633,643	**10.99**	3.82
Write down of unproved petroleum and natural gas interests	**724,915**	934,771	**N/A**	N/A
	11,813,535	4,501,727	**66.12**	30.43
Earnings (loss) before undernoted	**(3,799,813)**	2,095,255	**(12.30)**	9.28
Gain on sale of property and equipment	**-**	26,269,113	**-**	N/A
Net earnings (loss) for the year	**(3,799,813)**	28,364,368	**(12.30)**	9.28

(1) As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.

DETAILED FINANCIAL ANALYSIS

PRODUCTION

Heritage's net 2005 condensate, LPG and crude oil production averaged 458 bpd, 11% higher than the previous year.

Average Net Annual Production	2005 Bpd	2004 Bpd
Congo	**318**	195
Oman		
Condensate	**69**	148
LPG	**71**	70
	140	218
	458	413

Net production from the Kouakouala field, Congo averaged 318 bpd in 2005, 63% higher than in 2004. The increase arose from an additional producing well (KKL-401) brought on production in the first quarter of 2005. The field, however, suffers from a lack of reservoir pressure, making the decline in production quite rapid. Technical evaluation has determined that water injection will be required to maintain reservoir pressure, increase production and maximize the level of recoverable reserves. A previous well drilled off-structure was side-tracked in the first quarter of 2005 with the aim of using the water encountered as part of the secondary recovery program. Management had hoped that the operator would implement a water injection program in 2005, but this is still being considered.

Net production from the Bukha field, Oman declined from 218 bpd in 2004 to 140 bpd in 2005. This reduction is primarily due to the Government of Oman becoming entitled, during 2005, to a share of production after full cost recovery was achieved. Overall, gross field production of liquids declined by 6% to 2,748 bpd in 2005, which is in line with expectations for this mature asset.

PETROLEUM AND NATURAL GAS REVENUE

Petroleum and natural gas revenue increased by $693,981 (12%) in 2005 to $6,286,702. $1,273,919 of this increase resulted from a 25% increase in average commodity prices, offset by $579,938 from a 10% reduction in sales volumes. The average sales price per barrel increased from $33.66 in 2004 to $42.22 in 2005.

Revenue would have been higher in 2005, save for the periodic nature of condensate sales from the Bukha field, Oman. In 2004, 73,207 barrels of condensate were sold, compared to 8,975 in 2005. However, a sale of approximately 17,500 barrels of condensate net to Heritage took place in the first quarter of 2006.

Petroleum and natural gas revenue may be analyzed as follows:

		2005 $	2004 $	2005 $/bbl [1]	2004 $/bbl [1]
Congo		5,444,936	2,304,373	47.53	34.58
Oman					
	Condensate	468,816	2,991,096	52.24	40.86
	LPG	372,950	297,252	14.70	11.30
		841,766	3,288,348	24.51	33.05
		6,286,702	5,592,721	42.22	33.66

(1) *As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.*

During 2004 and 2005, all production from the Kouakouala field was sold to SOCAP, a subsidiary of TotalFinaElf. Condensate production from the Bukha field, Oman was sold to Sumitomo Corporation in 2005 and to Shell International Trading Middle East in 2004.

INTEREST AND OTHER INCOME

Interest income of $371,615 in 2005 was $189,275 (34%) lower than the previous year, as a result of lower average cash balances in 2005 and higher average interest rates in 2004, principally from a $14 million note receivable (denominated in Euros) that bore interest at Euribor +2.65%. The note receivable was repaid in three tranches during 2004 and 2005, with the final payment received in March 2005.

Other income in 2004 and 2005 included Heritage's share of a pipeline tariff in the Republic of Congo. Other income in 2005 also included drilling income of $342,973 from Heritage's 50% share of Eagle Drill. Eagle Drill is the drilling contractor for Hardman Resources in Block 2, Uganda. Hardman's Mputa-1 well was spudded in December 2005 and the drilling program has continued into 2006.

Cash and cash equivalents typically are held in interest-bearing treasury accounts.

OPERATING AND ROYALTY EXPENSES

Operating expenses increased by $211,641 (15%) in 2005 to $1,653,657. Total operating costs from the Kouakouala and Oman operations in 2005 were similar to the previous year. The increase in 2005 arose from Heritage's 50% share of Eagle Drill's operating costs from drilling in Block 2, Uganda.

GENERAL AND ADMINISTRATIVE

General and administrative expenses of $5,249,862 in 2005 were approximately double those incurred in the previous year. During the last 12 months, the Company has grown substantially, employing additional staff, appraising and undertaking operations in new territories and establishing a management and finance office in Switzerland. The Company's level of activity has increased during the last 12 months, notably linked

to the acquisition of the West Chumpass field in Russia and the two MOUs entered into in Kurdistan, Iraq.

General and administrative expenses in 2005 included $930,000 of one-time costs associated with financing the loan for the London technical services office and the establishment of the management and finance office in Lugano, Switzerland, costs which will not recur in 2006.

Additionally, general and administrative expenses in 2005 were higher than the previous year as they included costs of $625,365 from the amortization of the fair value of stock options granted in 2005 compared to $10,240 in 2004.

In 2005, the Company capitalized $1,332,363 (2004 - $441,075) of general and administrative costs relating to exploration and development activities.

INTEREST

Interest on the loan used to re-finance the purchase of the London technical services office in London, UK totaled $491,824 in 2005. This loan was obtained in January 2005. There was no interest charge in 2004 as Heritage was debt free throughout that year.

FOREIGN EXCHANGE LOSSES (GAINS)

There was a foreign exchange loss of $1,240,529 in 2005, primarily as a result of the relative weakening of the Euro against the US dollar. A $14 million note receivable (denominated in Euros) was repaid during the first quarter of 2005 and the funds were retained in Euro-denominated treasury deposits for part of this period.

DEPLETION, DEPRECIATION AND ACCRETION

Depletion, depreciation and accretion expenses increased by $1,002,365 to $1,636,008 in 2005. This was primarily as a result of a decrease in the level of proven reserves in the Kouakouala field, Congo as at December 31, 2005, which impacted on the depletion, depreciation and accretion expense in the fourth quarter of the year.

The depletion calculation includes future costs required to develop reserves in the amount of $625,000 in 2005 compared to $3,000,000 in 2004.

	2005 US$	2004 US$
Depletion, depreciation and accretion	1,566,370	614,260
Depletion, depreciation and accretion per barrel	9.38	4.08

ASSET RETIREMENT OBLIGATION

The charge for asset retirement obligation is based on production volumes for the period, relative to total proven reserves. It reflects current estimates of abandonment costs for wells and facilities in the areas where the Company is producing.

	2005 US$	2004 US$
Accretion expense	69,638	19,383
Accretion expense per barrel	0.42	0.13

GAIN ON SALE OF PROPERTY AND EQUIPMENT

On June 9, 2004, Heritage sold a call option to Maurel et Prom for proceeds of $1,200,000 entitling the purchaser to acquire the Company's overriding royalty interest in the Republic of Congo by July 30, 2004 for cash proceeds of $16,400,000, a loan note receivable equivalent to $14,000,000 (denominated in Euros of approximately € 11,600,000) due on December 31, 2005 bearing interest at Euribor + 2.65% per annum, together with contingent consideration of up to € 8,300,000 (approximately $10,000,000), payable on the sale of all or a portion of its interest in the M'Boundi Field or Kouilou Permit before December 31, 2005. Concurrent with the exercise of the option, Heritage was required to acquire a 7% working interest in the Noumbi Permit in the Republic of Congo from the purchaser for a cash consideration of $7,000,000.

On June 30, 2004, Maurel et Prom exercised the option, resulting in a gain on sale of $26,269,113 (Cdn$35,339,838). The net cash consideration of $9,400,000 was received in July 2004. The gain on the sale of the Kouilou overriding royalty was calculated after taking into account all relevant costs. The sale of the overriding royalty would have changed the rate of depletion and depreciation for the Republic of Congo by more than 20%. Accordingly, the capitalized cost pools and project values of the other projects from this country were taken into account when calculating the gain on sale of $26,269,113.

NET EARNINGS (LOSS) FOR THE YEAR

There was a net loss of $3,779,813 (Cdn$4.4 million) in 2005, compared to net earnings of $28,364,368 (Cdn$34.2 million) in 2004. Net earnings in 2004 were $2,095,255 before taking into account the one-off gain on the sale of property of $26,269,113.

If foreign exchange gains and losses and write-downs of petroleum and natural gas interests were excluded, the loss in 2005 would have been $1,834,369, compared to earnings of $1,542,000 in the previous year.

Net losses per Common Share were $0.18 (Cdn$.20) in 2005, compared to earnings per Common Share of $1.33 basic (Cdn$1.60) and $1.31 diluted (Cdn$1.58) in 2004.

CAPITAL EXPENDITURES

Additions to plant, property and equipment were $20,554,465 in 2005, compared to $37,318,136 in 2004. Capital expenditures in 2005 and 2004 may be analyzed by country and category as follows:

	2005 US$	2004 US$
Uganda		
Drilling	2,366,385	6,653,966
Seismic	1,059,395	4,130,388
Other	2,223,457	1,647,725
	5,649,237	12,432,079

		2005 US$	2004 US$
Congo			
	Drilling	1,683,333	1,030,931
	Other	979,068	498,793
	Acquisition of license interest	-	7,000,000
		2,662,401	8,529,724
Oman			
	Other	398,316	172,788
		398,316	172,788
Russia			
	Acquisition of license interest and other	6,558,966	871,950
		6,558,966	871,950
Other			
	Undeveloped lands	3,952,031	2,218,319
	Eagle Drill Rig refurbishment	638,613	640,812
	Corporate	694,899	12,452,464
		5,285,543	15,311,595
Total		20,554,463	37,318,136

At December 31, 2005, costs of $26,991,887 had been capitalized in Blocks 3A and 1 in Uganda. Given that Turaco-3 discovered a new hydrocarbon system (effective reservoir, seal and source) in the Albert Graben, the recent drilling success in the neighbouring Block 2 license that discovered oil and the prospectivity in the licenses, the management team considers there is no impairment to this value at year-end 2005.

CASH FLOW FROM OPERATIONS

Operating cash flows before financing and investing totaled $697,213 in 2005 compared to $1,866,009 in 2004. This equates to $0.03 per issued Common Share ($0.09 per Common Share in 2004).

FIXED PRICE CONTRACTS AND DERIVATIVE FINANCIAL INSTRUMENTS

The Company periodically adopts a hedging policy to mitigate certain exposure to commodity pricing risk. No derivative instruments were entered into in 2004 or 2005 or since the year-end.

CONTRACTUAL OBLIGATIONS

Heritage's net share of outstanding commitments at year-end 2005 are estimated at:

Payments Due by Period	Total US$m	Less than 1 year US$m	1 - 3 years US$m	4 - 5 years US$m	After 5 years US$m
Long Term Debt	7,768	248	246	246	7,028
Capital Lease Obligations	-	-	-	-	-
Operating Leases	2,659	217	434	434	1,574
Purchase Obligations	-	-	-	-	-
Other Long Term Obligations	875	588	287	-	-
Work Program Obligations	19,350	16,950	2,400	-	-
Total Contractual Obligations	**30,652**	**18,003**	**3,367**	**680**	**8,602**

The work program obligations comprise the estimated costs of minimum work programs set out in certain of the Company's licenses in Russia, Uganda and Oman. Save for the commitments set out in the table above, the Company is not aware of any other commitments that could affect the Company's future performance.

The Company may have a potential residual obligation to satisfy the shortfall in certain individuals' secured real estate borrowings in the event of default, a shortfall on the proceeds from the disposal of the properties and the individuals being unable to repay the balance. In the unlikely event this was to occur the Company would look to recover any monies directly from the individuals.

Heritage has not entered into any off balance sheet arrangements that would adversely impact on the Company's financial position or results of operations.

LIQUIDITY & CAPITAL RESOURCES

As at December 31, 2005, the Company had a working capital surplus of $5,650,773 ($19,125,890 at December 31, 2004). The Company's financial strategy is to fund its capital expenditure program and any potential acquisitions by selling non-core assets, reinvesting funds from operations, using existing treasury resources, finding new credit facilities and, when considered appropriate, either issuing unsecured convertible bonds or additional Common Shares.

The Company is considering the disposal of certain of its assets, which are considered non-core, to increase the Company's working capital surplus.

On March 27, 2006, the Company issued a $60,000,000 unsecured convertible bond, with a coupon of 10% and a term of five years and one day. The bond is convertible into Common Shares at a price of US$18.00 per share at any time during the term of the bond. The Company may redeem the bond in whole or part at any time during the first 12 months at 150% of par value. The Company has no redemption rights after the first 12 months. The proceeds of the bond can be employed for development of the West Chumpass field in Russia and for general corporate purposes.

DEBT

In January 2005, the Company received a sterling denominated loan of $8.45 million (£4.5 million) to refinance the acquisition of the technical services office at 34 Park Street, Mayfair, London W1K 2JD. Interest on the loan is fixed at 6.515% for the first five years and then is variable at a rate of LIBOR +1.35%. The loan, which is secured on the property, is scheduled to be repaid by 240 installments of capital and interest at monthly intervals, subject to a residual debt at the end of the term of the loan of $3.5 million (£1,860,000).

SHARE CAPITAL

During 2005, the Company issued 546,667 Common Shares on the exercise of options.

Heritage believes that the buy-back of its Common Shares represents an appropriate use of funds when, in the opinion of management, the market price of its Common Shares is at a discount to their fair value.

A Normal Course Issuer Bid program commenced on November 4, 2004, expired on November 3, 2005, and was replaced by a further Normal Course Issuer Bid program that commenced on November 4, 2005 and is scheduled to expire on November 3, 2006. Pursuant to the current Normal Course Issuer Bid, the Company may purchase up to 1,090,785 Common Shares. Pursuant to the previous normal course issuer bid that expired on November 3, 2005, the Company purchased an aggregate of 135,100 Common Shares at an average price of $7.85 per share, which were cancelled. No further acquisitions under the Normal Course Issuer Bid were made in 2005.

As at March 27, 2006, there were 21,865,701 Common Shares issued and outstanding.

NET ASSET VALUE

The table below summarizes the estimated net asset value per share at December 31, 2005:

Asset Value Per Issued Share At December 31, 2005	**US$**
Total Proved and Probable reserves at constant prices discounted at 10%	407,900,000 [1]
Undeveloped acreage at cost	31,596,465
Corporate and other assets	15,330,141
Deferred development costs	1,187,371
Debt	(7,520,438)
Working capital surplus	5,650,773
Total asset value	**454,144,312**
Issued shares outstanding at year end	21,865,701
Net asset value per issued share (US$)	20.77
Net asset value per issued share (Cdn$)	**24.21**

Note

[1] *The discounted total proved and probable reserves value noted above is net of development costs. Total development costs of the West Chumpass Field in Russia are estimated over the life of the field at between $150 and $200 million. Development costs are estimated to be incurred between 2006 and 2013, with peak expenditure expected in 2007.*

RELATED PARTY TRANSACTION

In 2005, general and administrative expenses included an advisory fee of $877,686 (2004 - $429,208) charged by a director of the Company. The Company established a management and finance office in Switzerland that required this director to relocate and he received a relocation allowance of $275,918.

RESULTS FOR FOURTH QUARTER, 2005

		Three months to December 31 2005 $	Three months to December 31 2004 $	Three months to December 31 2005 $/bbl [(1)]	Three months to December 31 2004 $/bbl [(1)]
Revenue					
	Petroleum and natural gas	1,297,072	637,154	44.08	30.25
	Interest	45,756	173,711	1.55	8.25
	Other	662,332	229,985	N/A	N/A
		2,005,160	1,040,850	45.63	38.50
Expenses					
	Operating	559,246	242,009	19.00	11.49
	Royalties	177,978	83,175	6.05	3.95
	General & administrative	2,652,013	936,312	90.12	44.46
	Interest	133,125	-	4.52	-
	Foreign exchange (gains) losses	8,759	(1,568,856)	0.30	(74.49)
	Depletion, depreciation and accretion	612,432	174,335	20.81	8.28
	Write down of unproved petroleum and natural gas interests	724,915	934,771	N/A	N/A
		4,868,468	801,746	140.80	(6.32)
Net earnings (loss) for the period		(2,863,308)	239,104	(95.17)	44.81

(1) *As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.*

Production in the fourth quarter averaged 391 bpd, 7% higher than in the same period of the previous year, as analyzed below:

	Three months to December 31 2005 Bpd	Three months to December 31 2004 Bpd
Bukha field, Oman		
Condensate	47	135
LPG	66	63
	113	198
Kouakouala field, Congo	278	168
	391	366

Net production from the Kouakouala field, Congo averaged 278 barrels in the fourth quarter of 2005, 66% higher than in 2004. This increase arose from a fourth producing well (KKL-401) brought on production in the first quarter of 2005. Net production from the Bukha field, Oman reduced from 198 bpd in Q4 2004 to 113 bpd in the fourth quarter of 2005. This reduction is primarily due to costs being now fully recovered which has resulted in the Government of Oman being entitled to a share of production. Overall, gross field production of liquids reduced by 3% to 1,922 bpd in Q4 2005, which is in line with expectations for this mature asset.

Petroleum and natural gas revenue in the fourth quarter was $1,297,072, 104% higher than in the same period in the previous year. This increase included $406,864 from higher average commodity prices and $253,054 from increased sales volumes. The increased sales volumes arose from the Kouakouala field, Congo.

	Three months to December 31 2005 $	Three months to December 31 2004 $	Three months to December 31 2005 $/bbl[1]	Three months to December 31 2004 $/bbl[1]
Congo	1,186,521	554,500	50.86	37.67
Oman				
Condensate	-	-	-	-
LPG	110,551	82,654	18.13	13.03
	110,551	82,654	18.13	13.03
	1,297,072	637,154	44.08	30.25

[1] *As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.*

General and administrative expenses of $2,652,013 in Q4 2005 were considerably higher than in the same period in the previous year. General and administrative expenses in the fourth quarter 2005 included a number of one-off costs associated with the establishment of the management and finance office in Lugano, Switzerland that will not recur in 2006. Overall, however, the size of the Company's operations have grown year on year, with new projects acquired in a number of new territories with an associated increase in overhead costs. This increased level of activity has yet to result in increased revenues, but significant increases in revenues from growth in production are reasonably expected to occur within the next 36 months.

There was a net loss of $2,863,308 in the fourth quarter, compared to net earnings of $239,104 in Q4 2004. The net loss in the fourth quarter of 2005 principally arose from higher general and administrative expenses, increased depletion, depreciation and accretion charges following the reduction in proven reserves in the Kouakouala field, Congo, and the $724,915 write-down of unproved interests in Nigeria and Turkmenistan.

SELECTED QUARTERLY FINANCIAL INFORMATION

IN US DOLLARS EXCEPT FOR PRODUCTION

	2005 Q4	2005 Q3	2005 Q2	2005 Q1	2004 Q4	2004 Q3	2004 Q2	2004 Q1
PRODUCTION								
Petroleum and natural gas (bpd)	**391**	**513**	**458**	**470**	366	398	406	485
FINANCIAL								
Petroleum and natural gas revenue	**1,297,702**	**1,809,630**	**1,729,613**	**1,450,387**	637,154	2,483,908	646,733	1,824,926
Net earnings (loss)	**(2,863,308)**	**195,620**	**(695,497)**	**(437,528)**	239,104	2,059,354	25,729,898	336,012
Net earnings (loss) per share - basic	**(0.14)**	**0.01**	**(0.03)**	**(0.02)**	0.01	0.10	1.21	0.02
Net earnings (loss) per share - diluted	**(0.14)**	**0.01**	**(0.03)**	**(0.02)**	0.01	0.09	1.19	0.02

SELECTED QUARTERLY FINANCIAL INFORMATION CONTINUED

	2005 Q4	2005 Q3	2005 Q2	2005 Q1	2004 Q4	2004 Q3	2004 Q2	2004 Q1
Capital expenditures	8,750,613	3,400,271	5,276,949	3,126,632	19,518,252	4,738,953	11,103,024	1,957,907
Shares outstanding	21,865,701	21,815,701	21,780,101	21,428,534	21,454,134	21,385,134	21,300,134	21,046,800
PER UNIT								
Petroleum and natural gas $/bbl (1)	44.08	48.27	41.75	35.75	30.25	40.74	27.97	29.93

(1) *As a result of the periodic nature of condensate sales from the Bukha field, Oman, $/bbl is based on net sales volumes rather than net production volumes.*

TRADING RANGE OF COMMON SHARES

	HIGH CDN$	LOW CDN$	CLOSE CDN$	VOLUME
2005				
Fourth Quarter	17.04	8.05	14.45	2,911,997
Third Quarter	15.25	8.10	15.00	4,639,513
Second Quarter	9.85	6.36	9.00	2,900,025
First Quarter	9.19	7.02	7.98	1,597,490
2004				
Fourth Quarter	9.40	5.60	8.65	2,113,036
Third Quarter	7.00	4.70	6.66	1,406,034
Second Quarter	5.35	3.44	4.70	1,287,750
First Quarter	5.10	2.70	4.25	2,662,478

- Record share prices, with a high of Cdn$17.04 per share reached during the fourth quarter of 2005.
- A 67% increase in share price in 2005.
- A 61% increase in trading volumes in 2005 compared to 2004.

OUTLOOK FOR 2006

The Company's business plan for 2006 includes the following drilling programs:

- *Russia*

  It is planned to re-enter an existing well that produced 462 bpd under production test in the West Chumpass Field, and a five-well drilling program is slated to commence in the final quarter of the year.

- *Sultanate of Oman*

  An appraisal well in the West Bukha field, Block 8, is scheduled to be drilled in the second quarter of 2006.

- *Uganda*

  Two exploration wells are planned to be drilled from the shore of Lake Albert, targeting the Kingfisher Prospect, Block 3A. The Kingfisher Prospect has been mapped by two seismic programs.

- *Republic of Congo*

  Following the ratification of the Noumbi Permit by the Government of Congo, an exploration well is being considered.

  An exploration well is planned to appraise a shallower potential target in the Kouakouala field. Further production wells are being considered.

Production in 2006 is estimated as follows:

- *Russia*

  Early production from the West Chumpass field is being considered by re-entering an existing well and trucking the oil. Commercial production is planned to commence in 2007 from a five-well drilling program slated to commence in the final quarter of this year.

- *Sultanate of Oman*

  Condensate and LPG production from the Bukha field, Oman is expected to continue to decline from this mature field.

  Condensate, LPG and gas production from the West Bukha field, Oman could commence towards the end of 2006 following the drilling of an appraisal well planned in the second quarter of this year.

- *Republic of Congo*

  Production from the Kouakouala field in Congo will continue to decline unless either a water injection program is implemented or further production wells are drilled.

Heritage acquired a 95% equity interest in the West Chumpass field in 2005. This field was discovered in 1997. A total of nine wells have been drilled on the License. On production test, the reservoir flowed sweet, 36 degree API crude, with moderate gas oil ratios, at rates up to 462 bpd per well.

Heritage intends to establish early production this year from re-entry of an existing wellbore and to fast-track the development of the field. Commercial production from the field is expected to commence in 2007, increasing to an estimated peak of approximately 17,500 bpd in 2013. Total gross development costs of the field are estimated between US$150 and $200 million. Development costs are estimated to be incurred between 2006 and 2013, with peak expenditure expected in 2007. The Company's financial strategy is to fund development costs through new credit facilities, reinvesting its funds from operations, using its existing treasury resources and, when considered appropriate, issuing unsecured convertible bonds and additional Common Shares.

Heritage is in negotiation with a number of governments and entities in the Middle East, Russia and the CIS for the purchase of additional attractive assets, and is focusing on opportunities that have the potential to increase shareholder value by increasing the Company's reserve base and production.

Heritage is also considering the sale of certain of its assets, which are considered non-core, in order to maximize shareholder value and generate cash to finance more attractive opportunities in the three strategic areas being pursued by the Company.

The Company's operational results and financial condition will be dependent on the prices received for oil and natural gas production. Oil and natural gas prices have fluctuated widely during recent years and are determined by demand and supply factors, including weather and general economic conditions, as well as conditions in other oil and natural gas regions.

Management is aware that currently producing assets are not sufficient to provide desired growth rates. The Company is fast-tracking the development of the West Chumpass Field and actively pursuing a number of additional opportunities and acquisitions to maximize growth and shareholder value.

FORWARD-LOOKING STATEMENTS

Except for statements of historical fact, all statements in this MD&A - including, without limitation, statements regarding production estimates, potential reserves and future plans and objectives of Heritage - are forward-looking statements that involve various risks and uncertainties. There can be no assurance that such statements will prove to be accurate; actual results and future events could differ materially from those anticipated in such statements. Important factors that could cause actual results to differ materially from anticipated results include risks and uncertainties most of which are beyond Heritage's control such as: risks relating to estimates of reserves and recoveries; production rates and operating cost assumptions; development risks and costs; the risk of commodity price and currency fluctuations; general economic and industry conditions; political and regulatory risks; environmental risks; stock market volatility; access to sufficient capital from internal and external sources; and other risks and uncertainties as disclosed under the heading "Risk Factors" and elsewhere in Heritage's documents filed from time-to-time with the Canadian securities regulatory authorities. The reader is cautioned that assumptions used in the preparation of such information, while considered reasonable by Heritage at the time, may prove to be incorrect. The Company disclaims any intention or obligation to update or revise any forward-looking statements, whether as a result of new information, future events or otherwise.

DISCLOSURE CONTROLS AND PROCEDURES

Disclosure controls and procedures have been designed to ensure that information required to be disclosed by the Company is accumulated and communicated to the Company's management as appropriate to allow timely decisions regarding required disclosures. The Company's Chief Executive Officer ("CEO") and Chief Financial Officer ("CFO") have concluded, based on their evaluation as of the end of the period covered by this MD&A, that the Company's disclosure controls and procedures are effective to provide reasonable assurance that material information related to the Company, including its consolidated subsidiaries, is made known to them by others within those entities. It should be noted that while the Company's CEO and CFO believe that the Company's disclosure controls and procedures provide a reasonable level of assurance

that they are effective, they do not expect that the disclosure controls and procedures or internal control over financial reporting will prevent all errors and fraud. A control system, no matter how well conceived or operated, can provide only reasonable, not absolute, assurance that the objectives of the control system are met.

CRITICAL ACCOUNTING ESTIMATES

The notes to the financial statements outline Heritage's significant accounting policies. The policies discussed below are considered particularly important, as they require management to make significant judgments, some of which may relate to matters that are inherently uncertain.

FINANCIAL STATEMENTS AND USE OF ESTIMATES

The consolidated financial statements of the Company have been prepared by management in accordance with accounting principles generally accepted in Canada. In preparing financial statements, management makes informed judgments and estimates that affect the reported amounts of assets and liabilities as of the date of the financial statements and affect the reported amounts of revenues and expenses during the reported period. Actual results will differ from these estimates.

ACCOUNTING FOR OIL AND GAS OPERATIONS

The Company follows the full cost method of accounting for petroleum and natural gas operations, whereby all costs related to the acquisition, exploration and development of petroleum and natural gas interests are accumulated within cost centres on a country-by-country basis.

Proceeds from the sale of petroleum and natural gas interests are applied against capitalized costs except for sales that would change the rate of depletion and depreciation by 20% or more, in which case a gain or loss is recorded.

Capitalized costs, together with estimated future capital costs associated with proved reserves, are depleted and depreciated using the unit of production method based on estimated gross proved reserves of petroleum and natural gas as determined by independent engineers. Costs of acquiring and evaluating significant unproved petroleum and natural gas interests are excluded from costs subject to depletion and depreciation until it is determined that proved reserves are attributable to such interest or until impairment occurs.

A revision to the estimate for proved reserves can have a significant impact on earnings as they are a key component in the calculation of depreciation, depletion and accretion.

An impairment loss is recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of the undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Undeveloped lands are assessed quarterly to determine whether impairment has occurred. Where interests are considered impaired, the cost of the property or the amount of impairment is included in costs subject to depletion and the ceiling test.

A substantial portion of the Company's exploration and development activities are conducted jointly with others. The financial statements reflect only the Company's proportionate interests in such activities.

INDEPENDENT EXPERTS

Heritage retained ECL Canada with support from RPS Scott Pickford Limited, an independent geoscience consultancy firm, to evaluate 100% of the Company's proved and probable oil and natural gas reserves. The estimation of reserves is subjective. Forecasts are based on engineering data, future prices, expected future rates of production and the timing of capital expenditures, all of which are subject to uncertainties and interpretations. Reserve estimates will be revised upward or downward based on the results of future drilling, testing and production levels.

Heritage employs the accounting firm KPMG LLP to audit its year-end financial statements and to review its quarterly reports before distribution to shareholders. Audit representatives meet with the Audit Committee of the Board of Directors prior to the release of quarterly or annual financial information. The Company also uses KPMG LLP to provide tax services but does not use KPMG LLP to provide any other consulting services.

NEW ACCOUNTING PRONOUNCEMENTS

The Canadian Securities Administrators have developed new continuous disclosure requirements for reporting issuers which are contained in National Instrument 51-102 Continuous Disclosure Obligations ("NI 51-102") effective March 31, 2004. NI 51-102 sets out rules and deadlines for financial statements, management's discussion and analysis ("MD&A"), Annual Information Forms ("AIF"), material change reporting, information circulars and other continuous disclosure matters.

Effective January 1, 2004, the Canadian Institute of Chartered Accountants ("CICA") mandated that entities use the fair value method of accounting for the granting of stock options. This method requires entities to recognize the cost of stock-based compensation over the vesting period of the option. The changes have had a minimal impact on the Company.

In December 2001, CICA issued Accounting Guideline 13 – Hedging Relationships – that deals with the identification, designation, documentation and measurement of effectiveness of hedging relationships for the purpose of applying hedge accounting. The guideline is effective for fiscal periods beginning on or after July 1, 2003. The guideline has not had an immediate impact on Heritage as it has not entered into any recent hedging arrangements.

In September 2003, Accounting Guideline 16 – Oil and Gas Accounting – Full Cost – was issued to supplement Accounting Guideline 5. The new guideline amends the ceiling test calculation applied by companies to its oil and natural gas assets. The guideline is effective for fiscal periods beginning on or after January 1, 2004.

In October 2003, CICA re-issued Handbook Section 1100 – Generally Accepted Accounting Principles. The most significant amendment has been the elimination of using industry practice in situations where Canadian generally accepted accounting principles are silent. The changes in Section 1100 have had a minimal impact on the Company.

CICA issued a new standard to account for asset retirement obligations. The new standard requires recognition of a liability for the future retirement obligations associated with the Company's oil and natural gas properties. The retirement obligation is initially measured at fair value, which is the discounted future value of the liability. This fair value is capitalized as part of the cost of the related asset and amortized to expense over its useful life. The liability accretes until the date of expected settlement of the retirement obligation. The new standard is effective for all fiscal periods beginning on or after January 1, 2004. The changes have had a minimal impact on the Company.

BUSINESS RISKS AND UNCERTAINTIES

The international energy business is subject to risks in exploration, development and production activities. These activities can expose the Company to risks of destruction of assets, well blowouts and other operational events. Heritage has purchased certain liability insurance to protect its international assets and activities from such risks where it is considered appropriate.

The Company has very limited control over external factors such as oil and gas prices, foreign exchange rates and government regulations. Where appropriate, the Company manages commodity price risks by using commodity hedging programs that have the primary goal of minimizing significant downward movements in commodity prices.

The international petroleum sector is very competitive and the Company is thus in competition with many other participants in the search for and acquisition of suitable properties, the marketing of oil and gas production, as well as developing successful partnership groups and accessing appropriately priced sources of additional capital.

The Company operates in various developing countries, some of which have historically experienced periods of civil and political unrest and economic instability. Heritage's properties are located in relatively remote areas, some of which are difficult to access. There can be no assurances that future instability within such countries, or actions by other companies, host governments, or the international community may not have a material adverse effect.

Products are transported to markets by third parties and closure of facilities or pipelines may occur over which the Company has little control.

As is common throughout the industry, the Company's operations are environmentally sensitive and spills and other damage can occur for which the Company and its partners are liable for reclamation costs. The Company believes that it follows best international oil field practices in this area. Insurance may also be obtained to cover certain aspects.

There are a number of uncertainties inherent in estimating the quantities of oil and natural gas reserves. Reservoir engineering is a subjective process of estimating underground accumulations that cannot be measured precisely, and the accuracy of any estimate is a function of the quality of available data and of engineering, geological interpretation and judgment. Our reserves are evaluated by an independent reservoir engineering firm each year.

The Company's future success is dependent on its ability to find or acquire additional reserves that are economically recoverable. Without successful exploration and development activities, the reserves of the Company will decline, which could impact operating cash flows and results of operations. This risk may be managed by using strict economic criteria for new projects and retaining highly-skilled, knowledgeable personnel in all phases of oil operations.

ENVIRONMENTAL, HEALTH AND SAFETY

Heritage is committed to conducting its activities in an environmentally responsible manner, protecting the health and safety of its employees and the public in every country in which it operates. It is a condition of employment that Heritage personnel work safely and in accordance with established regulations and procedures. Heritage strives to improve areas of environment, health and safety performance, working with local communities in order to:

- Reduce long-term environmental liabilities through decommissioning, abandoning and reclaiming well leases and facilities.
- Monitor long-term liabilities through regular inspections.
- Minimize and reduce flaring and greenhouse gas emissions.
- Minimize waste products by reducing, recycling and recovering.

CORPORATE GOVERNANCE

Heritage is committed to a high standard of corporate governance practices. The Company believes good corporate governance is in the best interest of shareholders and successful companies deliver growth and a competitive return alongside a commitment to the environment, to the communities where they operate and to their employees.

Heritage complies with the objectives and guidelines relating to corporate governance adopted by the Toronto Stock Exchange. In addition, the Board monitors and considers the implementation of corporate governance standards proposed by various regulatory and non-regulatory authorities in Canada. A full examination of the Company's corporate governance policies will be provided in the information circular to be provided for the annual general meeting, which will be filed on SEDAR (www.sedar.com) in due course.

March 27, 2006

Auditors' Report to the Shareholders

We have audited the consolidated balance sheets of Heritage Oil Corporation as at December 31, 2005 and 2004 and the consolidated statements of earnings (loss) and retained earnings and cash flows for the years then ended. These financial statements are the responsibility of the Corporation's management. Our responsibility is to express an opinion on these financial statements based on our audits.

We conducted our audits in accordance with Canadian generally accepted auditing standards. Those standards require that we plan and perform an audit to obtain reasonable assurance whether the financial statements are free of material misstatement. An audit includes examining, on a test basis, evidence supporting the amounts and disclosures in the financial statements. An audit also includes assessing the accounting principles used and significant estimates made by management, as well as evaluating the overall financial statement presentation.

In our opinion, these consolidated financial statements present fairly, in all material respects, the financial position of the Corporation as at December 31, 2005 and 2004 and the results of its operations and its cash flows for the years then ended in accordance with Canadian generally accepted accounting principles.

KPMG LLP

Chartered Accountants

Calgary, Canada

March 22, 2006, except note 13 which is as of March 27, 2006

Consolidated Balance Sheets

DECEMBER 31, 2005 AND 2004 (US DOLLARS)

	2005	2004
ASSETS		
CURRENT ASSETS:		
Cash and cash equivalents	$ 8,583,321	$ 16,235,523
Accounts receivable	1,318,450	4,640,802
Note receivable (note 7)	–	4,280,161
Inventories	216,474	94,483
Prepaid expenses	219,222	272,168
	10,337,467	25,523,137
Property and equipment (note 3)	72,382,935	54,083,097
Deferred development costs	1,187,371	1,013,012
	$ 83,907,773	$ 80,619,246
LIABILITIES AND SHAREHOLDERS' EQUITY		
CURRENT LIABILITIES:		
Accounts payable and accrued liabilities	$ 4,438,649	$ 6,397,247
Current portion of long-term debt	248,045	–
	4,686,694	6,397,247
Long-term debt	7,520,438	–
Asset retirement obligations (note 5)	434,849	328,553
SHAREHOLDERS' EQUITY:		
Share capital and warrants (note 6 (b))	22,854,418	21,434,168
Contributed surplus (note 6 (g))	517,209	24,421
Retained earnings	47,894,165	52,434,857
	71,265,792	73,893,446
Commitments (note 12)		
Subsequent events (note 13)		
	$ 83,907,773	$ 80,619,246

See accompanying notes to consolidated financial statements.

On behalf of the Board:

Director

Director

Consolidated Statements of Earnings (Loss) and Retained Earnings

YEARS ENDED DECEMBER 31, 2005 AND 2004 (US DOLLARS)

	2005	2004
REVENUE:		
Petroleum and natural gas	$ 6,286,702	$ 5,592,721
Interest	371,651	560,926
Other	1,355,369	443,335
	8,013,722	6,596,982
EXPENSES:		
Operating	1,653,657	1,442,016
Royalties	816,740	345,656
General and administrative	5,249,862	2,633,667
Interest	491,824	–
Foreign exchange (gains) losses	1,240,529	(1,488,026)
Depletion, depreciation and accretion	1,636,008	633,643
Write-down of unproved petroleum and natural gas interests (note 3)	724,915	934,771
	11,813,535	4,501,727
Earnings (loss) before the undernoted	(3,799,813)	2,095,255
Gain on sale of property and equipment (note 7)	–	26,269,113
Net earnings (loss)	(3,799,813)	28,364,368
Retained earnings, beginning of year	52,434,857	24,028,812
Effect of change in accounting for:		
Asset retirement obligations (note 5)	–	55,558
Stock-based compensation (note 6(g))	–	(13,881)
Premium on purchase and cancellation of Common Shares (note 6(e))	(740,879)	–
Retained earnings, end of year	$ 47,894,165	$ 52,434,857
Net earnings (loss) per share (note 6 (f)):		
Basic	$ (0.18)	$ 1.33
Diluted	$ (0.18)	$ 1.31

See accompanying notes to consolidated financial statements.

CONSOLIDATED FINANCIAL STATEMENTS

Consolidated Statements of Cash Flow

YEARS ENDED DECEMBER 31, 2005 AND 2004 (US DOLLARS)

	2005	2004
CASH PROVIDED BY (USED IN):		
OPERATING:		
Net earnings (loss)	$ (3,799,813)	$ 28,364,368
Items not involving cash:		
Gain on sale of property and equipment (note 7)	–	(26,269,113)
Depletion, depreciation and accretion	1,636,008	633,643
Foreign exchange (gains) losses	480,253	(1,910,662)
Stock-based compensation	625,365	10,540
Write-down of unproved petroleum and natural gas interests (note 3)	724,915	934,771
Changes in non-cash operating working capital	1,030,395	102,462
	697,123	1,866,009
FINANCING:		
Shares issued for cash	1,423,011	604,953
Long-term debt	8,577,350	–
Purchase of Common Shares for cancellation	(876,217)	–
Repayment of long-term debt	(103,997)	–
	9,020,147	604,953
INVESTING:		
Property and equipment expenditures	(20,554,465)	(37,318,136)
Proceeds on sale of property and equipment	–	16,400,000
Repayment of note receivable	4,210,538	10,724,500
Development expenditure	(174,359)	(210,957)
Acquisition (note 4)	–	(285)
Changes in non-cash investing working capital	333,937	(905,434)
	(16,184,349)	(11,310,312)
Foreign exchange gains (losses) on cash held in foreign currency	(1,185,123)	906,001
Decrease in cash and cash equivalents	(7,652,202)	(7,933,349)
Cash and cash equivalents, beginning of year	16,235,523	24,168,872
Cash and cash equivalents, end of year	$ 8,583,321	$ 16,235,523
Supplementary information:		
Interest received	$ 397,640	$ 556,897
Interest paid	$ 491,824	$ –

See accompanying notes to consolidated financial statements.

Notes to the Consolidated Financial Statements

YEARS ENDED DECEMBER 31, 2005 AND 2004

(US DOLLARS)

Heritage Oil Corporation (the "Corporation") is incorporated under the Business Corporations Act (Alberta) and its primary business activity is the exploration, development and production of petroleum and natural gas in the Middle East, Africa and Russia.

The preparation of the consolidated financial statements in conformity with Canadian generally accepted accounting principles requires management to make estimates and assumptions that affect the reported amounts of assets and liabilities and disclosure of contingent assets and liabilities at the dates of the consolidated financial statements and the reported amounts of revenue and expenses during the reporting periods. Actual results could differ from those estimates.

1. Significant accounting policies:

   (a) Basis of presentation:

   The consolidated financial statements include the accounts of the Corporation, its subsidiaries and its proportionate interests in corporate joint ventures.

   The majority of the Corporation's business is transacted in US dollars and, accordingly, the functional and reporting currency is US dollars.

   (b) Joint operations:

   Substantially all exploration, development and production activities are conducted jointly with others and accordingly, the Corporation only reflects its proportionate interest in such activities.

   (c) Cash and cash equivalents:

   The Corporation considers deposits in banks, certificates of deposit and short-term investments with original maturities of three months or less as cash and cash equivalents.

   (d) Inventories:

   Inventories consist of petroleum, condensate and liquid petroleum gas that are recorded at the lower of cost, at average cost basis, and net realizable value.

   (e) Property and equipment:

   The Corporation follows the full cost method of accounting for petroleum and natural gas operations, whereby all costs related to the acquisition, exploration and development of petroleum and natural gas interests are accumulated within cost centres on a country-by-country basis. Such costs include land acquisition costs, geological and geophysical expenses, carrying charges on non-producing interests, costs of drilling both productive and non-productive wells, major development projects and overhead charges directly relating to acquisition, exploration and development activities.

   Proceeds from the sale of petroleum and natural gas interests are applied against capitalized costs except for sales that would change the rate of depletion and depreciation by 20% or more, in which case a gain or loss is recorded.

   Capitalized costs, together with estimated future capital costs associated with proved reserves, are depleted and depreciated using the unit of production method based on estimated gross proved reserves of petroleum and natural gas as determined by independent engineers.

1. Significant accounting policies (continued):

(e) Property and equipment (continued):

For purposes of this calculation, reserves and production are converted to equivalent units of petroleum based on relative energy content of six thousand cubic feet of natural gas to one barrel of petroleum.

Costs of acquiring and evaluating significant unproved petroleum and natural gas interests are excluded from costs subject to depletion and depreciation until it is determined that proved reserves are attributable to such interest or until impairment occurs.

The Corporation uses the full cost method of accounting for oil and gas activities. The method requires a detailed impairment calculation when events or circumstances indicate a potential impairment of the carrying amount of oil and gas assets may have occurred, but at least annually.

An impairment loss is recognized when the carrying amount of a cost centre is not recoverable and exceeds its fair value. The carrying amount is assessed to be recoverable when the sum of the undiscounted cash flows expected from proved reserves plus the cost of unproved interests, net of impairments, exceeds the carrying amount of the cost centre. When the carrying amount is assessed not to be recoverable, an impairment loss is recognized to the extent that the carrying amount of the cost centre exceeds the sum of the discounted cash flows from proved and probable reserves plus the cost of unproved interests, net of impairments, of the cost centre. The cash flows are estimated using expected future product prices and costs and are discounted using a risk-free interest rate.

Drilling rig equipment is depreciated using the unit-of-production method based on 2,740 drilling days with a 20% salvage value.

Corporate capital assets are amortized on a straight-line basis over their estimated useful lives. The building is amortized on a straight-line basic over 40 years.

(f) Asset retirement obligations:

The Corporation records the fair value of an asset retirement obligation as a liability in the period in which it incurs a legal obligation associated with the retirement of tangible long-lived assets that result from the acquisition, construction, development, and/or normal use of the assets. The associated asset retirement costs are capitalized as part of the carrying amount of the long-lived asset and depleted and depreciated using a unit of production method over estimated gross proved reserves. Subsequent to the initial measurement of the asset retirement obligations, the obligations are adjusted at the end of each period to reflect the passage of time and changes in the estimated future cash flows underlying the obligation.

(g) Deferred development costs:

Development costs related to specific projects that in the Corporation's view have a clearly defined future market are deferred and amortized on a straight line basis commencing in the year following that in which the new product development was completed. All other research and development costs are charged to earnings in the year incurred.

(h) Revenue recognition:

Revenues from the sale of petroleum and natural gas are recorded when title passes to an external party.

1. Significant accounting policies (continued):

(i) Income taxes:

The Corporation uses the asset and liability method of accounting for income taxes. Under the asset and liability method, future tax assets and liabilities are recognized for the future tax consequences attributable to differences between the financial statement carrying amounts of existing assets and liabilities and their respective tax bases. Future tax assets and liabilities are measured using enacted or substantively enacted tax rates expected to apply to taxable income in the years in which those temporary differences are expected to be recovered or settled. The effect on future tax assets and liabilities of a change in tax rates is recognized in income in the period that includes the date of enactment or substantive enactment.

(j) Derivative financial instruments:

The Corporation uses derivative financial instruments from time to time to hedge its exposure to commodity price fluctuations. The Corporation does not enter into derivative financial instruments for trading or speculative purposes.

The derivative financial instruments are initiated within the guidelines of the Corporation's risk management policy. This includes linking all derivatives to specific firm commitments or forecasted transactions. The Corporation believes the derivative financial instruments are effective as hedges, both at inception and over the term of the instrument, as the term and notional amount do not exceed the Corporation's firm commitment or forecasted transaction and the underlying basis of the instrument matches the Corporation's exposure.

The Corporation enters into hedges of its exposure to petroleum and natural gas commodity prices by entering into crude oil and natural gas swap contracts, options or collars when it is deemed appropriate. These derivative contracts, accounted for as hedges, are not recognized on the balance sheet. Realized gains and losses on these contracts are recognized in petroleum and natural gas revenue in the same period in which the revenues associated with the hedged transaction are recognized. Premiums paid or received are deferred and amortized to earnings over the term of the contract.

(k) Foreign currency translation:

Monetary items denominated in foreign currencies are translated to US dollars at exchange rates in effect at the balance sheet date and non-monetary items are translated at rates of exchange in effect when the assets were acquired or obligations incurred. Revenue and expenses are translated at rates in effect at the time of the transactions. Foreign exchange gains and losses are included in earnings.

(l) Stock based compensation plan:

The Corporation has a stock-based compensation plan, which is described in note 6. The Corporation accounts for all stock-based payments granted on or after January 1, 2002, using the fair value based method.

Under the fair value based method, stock-based payments are measured at the fair value of the consideration received, or the fair value of the equity instruments issued, or liabilities incurred, whichever is more reliably measurable.

1. Significant accounting policies (continued):

(l) Stock based compensation plan (continued):

The fair value of stock-based payments to non-employees is periodically re-measured until counterparty performance is complete, and any change therein is recognized over the period and in the same manner as if the Corporation had paid cash instead of paying with or using equity instruments. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognized at that date

No compensation cost is recorded for all other stock-based employee awards granted prior to January 1, 2004. Consideration paid by employees on the exercise of stock options is recorded as share capital. The Corporation discloses the pro forma effect of accounting for these awards under the fair value based method.

(m) Per share amounts:

Basic per share amounts are computed by dividing net earnings by the weighted average shares outstanding during the reporting period. Diluted per share amounts are computed similar to basic per share amounts except that the weighted average shares outstanding are increased to include additional shares from the assumed exercise of stock options, if dilutive. The number of additional shares is calculated by assuming that outstanding stock options were exercised and that the proceeds from such exercises were used to acquire common shares at the average market price during the reporting period.

(n) Measurement uncertainty:

The amounts recorded for depletion and depreciation of petroleum and natural gas interests and the provision for asset retirement obligation costs are based on estimates. The cost recovery ceiling test is based on estimates of proved reserves, production rates, petroleum and natural gas prices, future costs and other relevant assumptions. By their nature, these estimates are subject to measurement uncertainty and the effect on the consolidated financial statements of changes in such estimates in future periods could be significant.

(o) Comparative figures:

Certain prior year balances have been reclassified to conform to the current year's presentation.

2. Changes in accounting policies:

(a) Asset retirement obligations:

Effective January 1, 2004, the Corporation adopted a new Canadian accounting standard for asset retirement obligations. This standard focuses on the recognition and measurement of liabilities related to legal obligations associated with the future retirement of property, plant and equipment. Under this standard, these obligations are initially measured at fair value determined as the estimated future costs discounted to the present value and subsequently adjusted for the accretion of the discount factor and any changes in the underlying cash flows. The asset retirement cost is capitalized to the related asset and amortized into earnings over time. The effect of adoption of the new standard on the financial statements is disclosed in note 5.

Prior to January 1, 2004, an estimate of future abandonment and restoration costs was provided for using the unit of production method over estimated gross proved reserves.

(b) Full cost ceiling test:

Effective January 1, 2004, the Corporation adopted a new Canadian guideline on the application of full cost accounting, described in note 1(e). The guideline modifies how impairment is tested.

Prior to January 1, 2004, an impairment loss was recognized when the carrying amount of a cost centre exceeded its recoverable amount. The recoverable amount was the sum of the undiscounted cash flows expected from the production of proved reserves plus the lower of cost or market of unproved interests less estimated future costs for administration, financing and site restoration. The cash flows were estimated using period end prices and costs.

Adoption of the new guideline had no effect on the Corporation's financial statements.

(c) Stock-based compensation:

Effective January 1, 2004, the Corporation retroactively adopted the revised Canadian accounting standard for stock-based compensation and other stock-based payments described in note 1(l), without restatement of prior periods.

Prior to January 1, 2004, no compensation cost was recorded for stock options granted to employees and directors. The Corporation previously disclosed the pro forma effect of accounting for these awards under the fair value based method.

The effect of adoption of the revised standard on the financial statements is disclosed in note 6(g).

3. Property and equipment:

	2005	2004
Petroleum and natural gas interests and equipment	**$ 73,159,179**	$ 54,514,733
Drilling equipment	**2,693,618**	2,055,006
Building	**11,984,701**	11,984,701
Other	**931,289**	297,692
	88,768,787	68,852,132
Accumulated depletion and depreciation	**(16,385,852)**	(14,769,035)
	$ 72,382,935	$ 54,083,097

3. Property and equipment (continued):

A ceiling test was undertaken at December 31, 2005 to determine whether there was an impairment to cost centres with proved reserves. In undertaking the ceiling test the following forecast prices were used:

Year	Brent $/bbl	Congo $/bbl	Bukha Condensate $/bbl	Bukha Propane $/tonne	Bukha Butane $/tonne	West Bukha Gas $/MMBTU	Russia Export $/bbl	Russia Domestic $/bbl
2006	55.50	54.00	56.16	360.19	370.24	1.00	50.60	29.91
2007	53.50	52.05	54.12	349.59	358.44	1.00	48.78	28.81
2008	49.50	48.16	50.05	328.39	334.84	1.00	45.13	26.63
2009	46.50	45.24	46.99	312.49	317.14	1.00	42.39	24.99
2010	45.00	43.78	45.47	304.54	308.29	1.00	41.03	24.17
2011	43.50	42.32	43.94	296.59	299.44	1.00	39.66	23.35
2012	43.50	42.32	43.94	296.59	299.44	1.00	39.66	23.35
2013	44.51	43.30	44.96	301.89	305.34	1.00	40.58	23.84
2014+	+2%pa	+2%pa	+2%pa	+2%pa	+2%pa	1.00	+2%pa	+2%pa

At December 31, 2005, the below new cost centres were considered to be in the preproduction stage and all costs, net of revenues, were capitalized in property and equipment and excluded from costs subject to depletion and depreciation.

	2005	2004
Uganda	**$ 26,991,887**	$ 21,342,651
Russia	**-**	871,950
Iraq	**2,785,419**	836,452
Democratic Republic of Congo	**464,285**	428,540
Kazakhstan	**938,370**	–
Pakistan	**416,504**	25,359
	$ 31,596,465	$ 23,504,952

Major uncertainties affect the recoverability of these costs as the recovery of the costs outlined above is dependent on the Corporation obtaining licenses, achieving commercial production or sale.

At December 31, 2005, the cost of unproved petroleum and natural gas interests of $11,727,768 (2004 - $11,247,096) for cost centres that are no longer in the preproduction stage have also been excluded from costs subject to depletion and depreciation.

In 2005, the Corporation capitalized $1,332,363 (2004 - $441,075) of general and administrative costs relating to exploration and development activities.

Following the acquisition of a 95% interest in the West Chumpass development license in 2005, costs in the Russian preproduction cost centre have been transferred into costs subject to depletion and depreciation.

Undeveloped lands are assessed quarterly to determine whether impairment has occurred. In the fourth quarter of 2005, the Corporation wrote-off all of the costs held in the Nigeria and Turkmenistan preproduction cost centres.

4. Natural Pipelay Worldwide Limited ("NPWL") and Naturalay Technologies Limited ("NTL"):

On July 23, 2003, the Corporation acquired a one-third interest in NPWL and NTL for a nominal cash consideration of $300 and a commitment to loan up to $500,000 for NPWL's development of the Buoyant Drum Lay System ("Pipelay System"). At December 31, 2005, NPWL and NTL, corporate joint ventures, were proportionately consolidated in the Corporation's financial statements as substantially all activities are conducted jointly with others.

On September 24, 2004, the Corporation acquired an additional 31.7% interest in both entities for a nominal cash consideration of $285 and a commitment to loan up to an additional $170,000 for the Pipelay System. Accordingly, the Corporation commenced proportionately consolidating the entities effective September 24, 2004. As the Pipelay System development is not complete to date, NPWL has no results of operations other than deferred development costs. At December 31, 2005, NTL had no assets, liabilities or operations.

Net assets acquired before non controlling interest	Previous consolidation	Acquired	Total
Working capital	$ 334,199	$ (330,708)	$ 3,491
Deferred development costs	265,803	531,608	797,411
Note payable from the Corporation, without interest	(500,002)	–	(500,002)
Note payable from other Shareholders	(100,000)	(200,000)	(300,000)
	–	900	900
Non-controlling interest	–	(315)	(315)
		$ 585	$ 585

Cash consideration	Acquired	Total
Initial 33.3% interest acquired in 2003	$ 300	$ 300
Incremental 31.7% interest acquired in 2004	285	285
	$ 585	$ 585

At December 31, 2005, the Corporation had also directly incurred deferred development costs of $63,133. In 2005, NPWL incurred deferred development costs of $174,359.

5. Asset retirement obligations:

The effect of the change in accounting policy as outlined in note 2(a) has been recorded retroactively with restatement of prior periods. The effect of the adoption on the balance sheet and statement of earnings is presented below as increases (decreases):

Balance sheet	At December 31, 2003
Asset retirement cost, included in property and equipment	$ 119,074
Asset retirement obligations	153,599
Accumulated future abandonment and site restoration liability	(90,083)
Retained earnings	55,558

The Corporation's asset retirement obligations result from net ownership interests in petroleum and natural gas assets including well sites and gathering systems. The Corporation estimates the total undiscounted amount of cash flows required to settle its asset retirement obligations is approximately $695,050, which is expected to be incurred in 2010. A credit-adjusted risk-free rate of eight percent was used to calculate the fair value of the asset retirement obligations.

A reconciliation of the asset retirement obligations is provided below:

	2005	2004
Balance, beginning of year	$ 328,553	$ 153,599
Additions	–	82,138
Revision	80,012	80,528
Accretion expense, included in depletion and depreciation	26,284	12,288
Balance, end of year	$ 434,849	$ 328,553

At December 31, 2005, estimated asset retirement obligation costs to be accreted over the remaining proved reserves were $255,202 (2004 - $234,529).

6. Share capital:

(a) Authorized:

Unlimited number of Common Shares without par value

(b) Issued:

	2005		2004	
	Number	Amount	Number	Amount
Common Shares				
Balance, beginning of year	21,454,134	$ 21,434,168	20,991,800	$20,788,253
Issued on exercise of stock options (c)	546,667	1,423,011	442,334	561,463

	2005		2004	
	Number	**Amount**	**Number**	**Amount**
Stock based compensation exercised (g)	–	**132,577**	–	–
Issued on exercise of warrants (d)	–	–	20,000	84,452
Normal course issuer bid (e)	**(135,100)**	**(135,338)**	–	–
Balance, end of year	**21,865,701**	**$ 22,854,418**	21,454,134	$ 21,434,168
Warrants				
Balance, beginning of year				40,962
Exercise of warrants				(40,962)
Balance, end of year				–
Share capital and warrants, end of year	**21,865,701**	**$ 22,854,418**	21,454,134	$ 21,434,168

(c) Stock options:

The Corporation has a stock option plan whereby certain directors, officers, employees and consultants of the Corporation may be granted options to purchase common shares. Under the terms of the plan, options granted normally vest one third immediately and one third in each of the years following the date granted and have a life of five years. In 2005, 150,000 options were issued to non-employees at an average exercise price of Cdn$12.00 per share and a term of 12 months. The cost of stock-based payments to non-employees that are fully vested and non-forfeitable at the grant date is measured and recognized at that date.

Common Share options outstanding and exercisable:

	2005		2004	
	Number of options	**Average exercise price (Cdn $)**	**Number of options**	**Average exercise price (Cdn $)**
Balance, beginning of year	**476,667**	**$ 1.31**	919,001	$ 1.49
Granted	**495,000**	**10.40**	–	-
Exercised	**(546,667)**	**3.12**	(442,334)	1.69
Balance, end of year	**425,000**	**$ 9.57**	476,667	$ 1.31
Share capital and warrants, end of year	**194,998**	**$ 9.42**	476,667	$ 1.31

	Number of options		Remaining
Exercise prices (Cdn $)	**Outstanding**	**Exercisable**	**Life (years)**
$1.35 - $2.88	30,000	30,000	1.40
$9.70 - $13.00	395,000	164,998	3.90
	425,000	194,998	3.73

6. Share capital (continued):

(d) Warrants:

The following outstanding Common Share warrants were issued pursuant to various private placements or borrowing arrangements.

	2005		2004	
	Number of warrants	Average exercise price (Cdn $)	Number of warrants	Average exercise price (Cdn $)
Balance, beginning of year	–	–	20,000	$ 2.80
Granted	–	–	–	–
Exercised	–	–	(20,000)	$ 2.80
Balance, end of year	–	–	–	–

(e) Normal course issuer bids:

On November 4, 2004, the Corporation renewed its normal course issuer bid to acquire up to 1,069,506 Common Shares on the open market until November 3, 2005. This was replaced by a normal course issuer bid program that commenced on November 4, 2005 and is scheduled to expire on November 3, 2006. Pursuant to the Normal Course Issuer Bid, the Corporation may purchase up to 1,090,785 Common Shares.

Pursuant to the normal course issuer bid that expired on November 3, 2005, the Corporation acquired 135,100 Common Shares at an average price of Cdn$7.85 per share for cancellation. No further acquisitions under the normal course issuer bid were made in 2005. No Common Shares were acquired in 2004.

(f) Per share amounts:

The following table summarizes the weighted average common shares used in calculating net earnings per share:

Weighted average common shares	2005	2004
Basic	**21,650,215**	21,247,565
Diluted	**21,860,371**	21,661,554

The reconciling item between basic and diluted weighted average number of Common Shares is the dilutive effect of stock options and warrants. A total of 150,000 options (2004 – nil) and nil warrants (2004 – nil) were excluded from the above calculation, as they were anti-dilutive.

(g) Stock based compensation:

The effect of the change in accounting policy as outlined in note 2(c) has been recorded retroactively without restatement of prior periods. At January 1, 2004, the effect of the change resulted in an increase to contributed surplus and an offsetting decrease to retained earnings of $13,881. A reconciliation of contributed surplus resulting from adoption is provided below:

		2005		2004
Balance, beginning of year	$	**24,421**	$	–
Adoption of change in accounting policy (note 2(c)		–		13,881
Stock-based compensation expense		**625,365**		10,540
Exercised		**(132,577)**		–
Balance, end of year	**$**	**517,209**	$	24,421

The fair value of each stock option grant on the date of grant was estimated using the Black-Scholes option-pricing model with the following weighted average assumptions and results. The fair value of stock options are amortized over the vesting period of the option. No stock options were granted in 2004.

		2005
Assumptions:		
Risk free interest rate		**2.81%**
Volatility		**58.86%**
Dividend yield		–
Expected life (in years)		**3.80**
Resulting weighted average fair value (Cdn $)	**$**	**3.93**

7. Gain on sale of property and equipment:

On June 9, 2004, the Corporation sold a call option for proceeds of $1,200,000 entitling the purchaser to acquire the Corporation's overriding royalty interest in certain petroleum and natural gas interests in the Republic of Congo for proceeds of $30,400,000 by July 30, 2004. An additional contingent consideration of up to €8,300,000 (approximately $10,000,000) may be payable on the sale of all or a portion of the interest by the purchaser by December 31, 2005. Concurrent with the exercise of the option, the purchaser would be required to sell a 7% working interest in another petroleum and natural gas interest in the Republic of Congo to the Corporation for $7,000,000.

On June 30, 2004, the purchaser exercised the option and the Corporation became entitled to a cash consideration of $9,400,000, net of the $7,000,000 to acquire the other interest, and a Euro-denominated note receivable equivalent to $14,000,000 due on December 31, 2005 bearing interest at Euribor plus 2.65% per annum. The net cash consideration of $9,400,000 was received in July 2004. On September 28, 2004 and December

1, 2004, the purchaser repaid early $4,000,000 and $6,724,500 respectively of the $14,000,000 note receivable. On March 17, 2005, the purchaser fully repaid the note receivable.

The sale of the unproved interest would have changed the rate of depletion and depreciation for the Republic of Congo by more than 20%; accordingly, a gain of $26,269,113 has been recognized in earnings.

8. Income taxes:

Heritage Oil Corporation is subject to income taxes in Canada. Substantially all of the Corporation's operating activities in 2004 and 2005 were outside of Canada in jurisdictions where the statutory tax rate is nil, since the producing assets in Oman and the Republic of Congo are subject to production sharing agreements. In 2005, the Corporation acquired a 95% interest in the West Chumpass license. The operations in Russia will be subject to income tax in Russia.

The Corporation has available tax deductions of approximately $10,976 (2004 - $92,633) and tax losses of approximately $3,944,517 (2004 - $3,334,846), which expire from 2006 to 2012. A valuation allowance has been applied to fully offset the future benefit of the tax deductions and losses.

9. Financial instruments:

(a) Fair value of financial assets and liabilities:

At December 31, 2005, the fair values of financial assets and liabilities are approximately equal to their carrying amounts due to the short maturities.

(b) Credit concentration and risk:

All of the Corporation's production is derived from the Republic of Congo and Sultanate of Oman. In 2005 and 2004, the Corporation sold all of its production, at any point in time, in each country to a single customer for each commodity. Accordingly, substantially all of the Corporation's accounts receivables from petroleum and natural gas sales were from three customers.

Debtors of the Corporation are subject to internal credit review to minimize the risk of non-payment. The Corporation does not anticipate any default as it transacts with creditworthy counterparties.

(c) Foreign exchange risk:

The Corporation is exposed to foreign exchange fluctuations as it holds working capital and long-term debt in foreign currencies. In addition, a portion of the operating activities are conducted in sterling and Swiss francs. There are no exchange rate contracts in place at, or subsequent to, December 31, 2005.

(d) Interest rate risk:

The Corporation is exposed to interest rate risks.

10. Long-term debt:

In January 2005, a wholly-owned subsidiary of the Corporation received a sterling denominated loan of $8.45 million (£4.5 million) to refinance the acquisition of a corporate office. Interest on the loan is fixed at 6.515% for the first five years and then is variable at a rate of London Interbank Offered Rate ("LIBOR") plus 1.35%. The loan, which is secured on the property, is scheduled to be repaid by 240 installments of capital and interest at monthly intervals, subject to a residual debt at the end of the term of the loan of $3.5 million (£1,860,000).

11. Related party transaction:

In 2005, general and administrative expenses included an advisory fee of $877,686 (2004 - $429,208) charged by a director of the Corporation. The Corporation established a management and finance office in Switzerland that required this director to relocate and he received a relocation allowance of $275,918.

12. Commitments:

Heritage's net share of outstanding commitments at year-end 2005 are estimated at:

Payments Due by Period	Total US$m	Less than 1 year US$m	1 - 3 years US$m	4 - 5 years US$m	After 5 years US$m
Long Term Debt	7,768	248	246	246	7,028
Capital Lease Obligations	-	-	-	-	-
Operating Leases	2,659	217	434	434	1,574
Purchase Obligations	-	-	-	-	-
Other Long Term Obligations	875	588	287	-	-
Work Program Obligations	19,350	16,950	2,400	-	-
Total Contractual Obligations	30,652	18,003	3,367	680	8,602

The Corporation may have a potential residual obligation to satisfy the shortfall in certain individuals' secured real estate borrowings in the event of default, a shortfall on the proceeds from the disposal of the properties and the individuals being unable to repay the balance. In the unlikely event this was to occur the Corporation would look to recover any monies direct from the individual.

13. Subsequent events:

On March 27, 2006, the Corporation issued a $60,000,000 unsecured convertible bond, with a coupon of 10% and a term of five years and one day. The bond is convertible into Common Shares at a price of US$18.00 per share at any time during the term of the bond. The Corporation may redeem the bond in whole or part at any time during the first 12 months at 150% of par value. The Corporation has no redemption rights after the first 12 months. The proceeds of the bond can be employed for development of the West Chumpass field in Russia and for general corporate purposes.

Corporate Information

BOARD OF DIRECTORS

ANTHONY BUCKINGHAM
Switzerland

MICAEL GULBENKIAN
Switzerland

PAUL ATHERTON
Switzerland

WILLIAM KAUFMANN*
Alberta, Canada

JOHN MCLEOD*
Alberta, Canada

GREGORY TURNBULL
Alberta, Canada

MICHAEL HIBBERD*
Alberta, Canada

**Members of the Audit Committee*

OFFICERS

MICAEL GULBENKIAN
Chairman and CEO

PAUL ATHERTON
Chief Financial Officer

SENIOR STAFF

PAUL BARNETT
VP Production

ARMEN SAHAKIAN
VP Business Development

BRIAN SMITH
VP Exploration

GHALIB MASAD
Iraq Regional Manager

JAMIL BABAN
Country Manager Iraqi Kurdistan

SAAD JASSIM
Iraq Asset Manager

MARTIN ALIKER
President, Heritage Uganda

BRYAN WESTWOOD
General Manager, Heritage Uganda

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Europe

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BG TRUST
Lugano, Switzerland

WIGGIN & CO.
Cheltenham, UK

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THE TORONTO STOCK EXCHANGE SYMBOL HOC

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HERITAGE OIL & GAS (U) LIMITED
HERITAGE CONGO LIMITED
EAGLE DRILL LIMITED
HERITAGE OIL & GAS (SWITZERLAND) SA
HERITAGE MIDDLE EAST LIMITED
COATBRIDGE ESTATES LIMITED
OOO CHUMPASSNEFTEDOBYCHA
HERITAGE OIL & GAS (AUSTRIA) GESMBH
HERITAGE INTERNATIONAL V.O.F


HERITAGE
Oil Corporation